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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 661

FIELD ENTERPRISES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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FIELD ENTERPRISES, INC., *Petitioner,* v. UNITED STATES OF AMERICA, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Claims.

OPINION BELOW

The opinion, findings of fact and conclusion of law of the United States Court of Claims (R. 56-96) are reported at Ct. Cl. , 348 F. 2d 485 (Ct. Cl. 1965) and are reprinted in Appendix A, *infra,* pp. 1a-41a.*

JURISDICTION

The judgment of the United States Court of Claims (Appendix A, *infra,* p. 41a) was entered on July 16, 1965. (R. 96.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1255(1).

*References to "R." are to the certified transcript of the record in this case.

QUESTIONS PRESENTED

1. The petitioner, through its sales force, sold merchandise under installment contracts. As provided by contracts with its sales personnel, the petitioner paid a portion of the sales commissions to such personnel upon the making of the sale; did not pay the balance if the purchaser of the merchandise breached his payment obligation; and, upon such breach by the purchaser, charged the portion of the commissions already paid against the unpaid portion of commissions credited to its sales managers on other sales. The following question of income tax accounting is presented: May the petitioner, an accrual basis taxpayer, accrue the unpaid portion of the sales commissions as deductions for the year of sale?

2. Is a deficiency assessment of income tax resulting from a second inspection of the petitioner's books of account for a taxable year made in violation of the written notification requirement of section 7605(b) of the Internal Revenue Code of 1954 invalid?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are sections 446(a), (b) and (c), 461(a) and 7605(b) of the Internal Revenue Code of 1954, 26 U. S. C. §§ 446(a), (b) and (c), 461(a) and 7605(b), and Treasury Regulations sections 1.446-1(a), (b) and (c), 1.461-1(a) and 301.7605(b), 26 C. F. R. §§ 1.446-1(a), (b) and (c), 1.461-1(a) and 301.7605(b). The pertinent portions of the statutes and regulations are set forth in Appendix B, *infra*, pp. 1b-5b.

STATEMENT OF THE CASE

The petitioner was, during the taxable years in issue, a publisher and seller of encyclopedias. (R. 65-66.) Most

of the petitioner's sales of encyclopedias were under installment contracts. (R. 66.) Sales were made through personal solicitation by the petitioner's salesmen. (R. 66.) Every purchaser was required to make a down payment and to execute a noncancelable purchase order. (R. 67.) An order became a binding contract if accepted by the petitioner after check for accuracy and credit standing. (R. 67.) Minimum terms for petitioner's most popular encyclopedia, which sold for $129, were $10 down and $6 a month. (R. 67.) The entire purchase price became payable if any installment remained unpaid for two months after it became due. (Jt. Exs. 3-5.)

On each sale the petitioner paid commissions both to the sales managers in charge of the geographical division and district in which the sale was made and to the salesman and other subordinate sales personnel. (R. 66, 74.) The amounts and terms for payment of the sales commissions were specified in written contracts between the petitioner and each member of its sales force. (R. 68, 71-74.) The $49 of commissions payable on a typical sale were allocated $13 to the division manager, $8 to the district manager and $28 to subordinate sales personnel. (R. 74.)

Upon the making of a sale, the petitioner paid its managers and subordinate sales personnel $42 of the $49 commissions and credited its managers with the remaining $7. (R. 71.) If the purchaser of the encyclopedia subsequently defaulted in his payment obligation, the petitioner charged its managers both with the $7 previously credited but not paid and with the $42 previously paid to them and their subordinates. (R. 77-78.)

The petitioner's procedure for the crediting and payment of commissions was as follows:

(1) The contracts with managers split the division manager's $13 commission into a $9 "basic commission"

and a $4 "quality bonus" and the district manager's $8 commission into a $5 "basic commission" and a $3 "quality bonus." (R. 74.)

(2) Upon the making of a sale, the petitioner (a) paid the managers their $14 of "basic commissions" and the subordinate sales personnel their $28 of commissions and (b) credited the managers with the $7 of "quality bonuses," which bonuses were payable to them unless the purchaser breached his payment obligation. (R. 71, 77-78.)

(3) The petitioner treated as breached (*i.e.*, as sales that had failed to become "bona fide") only those installment sales on which the purchaser failed to make at least two of the required monthly installment payments within six months following the sale. (R. 75-76.)

(4) If, at the expiration of such 6-month period, the sale had failed to become "bona fide," the petitioner charged the division manager with $13 (the $9 "basic commission" previously paid to him plus the $4 "quality bonus" previously credited to him on the sale) and charged the district manager with $36 (the $33 of commissions previously paid to him and his subordinates and the $3 "quality bonus" previously credited to him on the sale). (R. 78.)

(5) The petitioner settled with its managers at quarterly intervals with respect to sales for which the 6-month period referred to in paragraph (3) had expired by paying to each of them the excess of the amount of "quality bonuses" credited to him on such sales over the amount charged against him with respect to such sales. (R. 77-78.)

The petitioner kept its books and filed its income tax returns under the accrual method of accounting. (R. 65.) For each of the taxable years in issue, the petitioner accrued as sales on its books and on its income tax returns the full sales price of all encyclopedias sold during the taxable

year. (R. 78-79.) For each such taxable year, the petitioner also accrued as expenses the full amount of sales commissions paid or credited during the taxable year (as described in paragraph (2) above) less the amount charged against managers during the taxable year (as described in paragraph (4) above). (R. 80-81.) The petitioner then reduced such accrual by the amount expected, on the basis of the petitioner's experience, to be charged against managers in the future on sales for which the 6-month period referred to in paragraph (3) above was still open at the end of the taxable year. (R. 80-81.) The petitioner included the amount thus computed in its deduction for salaries and wages on its income tax return for the taxable year. (R. 83.)

During 1957 an Internal Revenue agent examined the petitioner's income tax return for the taxable year ended September 30, 1955, and, in the course of such examination, inspected the petitioner's books of account for that taxable year. (R. 85.) The Commissioner did not adjust the petitioner's deduction for sales commissions as a result of such examination, although he made other adjustments resulting in assessment and payment of a deficiency. (R. 87.)

Subsequently, during 1958, another Internal Revenue agent, while examining the petitioner's income tax return for the taxable year ended September 30, 1956, made a second inspection of the petitioner's books of account for the taxable year ended September 30, 1955 in violation of the written notification requirement of section 7605(b) of the Internal Revenue Code of 1954. (R. 88-90.) The petitioner had not requested the second inspection. (R. 90.) When the petitioner discovered that the unauthorized second inspection was being made, the petitioner objected. (R. 89, 90.) As the result of the second Internal Revenue agent's examination, the Commissioner disallowed a major

portion of the petitioner's deduction for quality bonuses for each of the taxable years ended September 30, 1955 and September 30, 1956. (R. 91-93.)

The petitioner seeks refund in this proceeding of the deficiencies in income tax resulting from such disallowances. (R. 95.) The United States Court of Claims, which had jurisdiction of the case under 28 U. S. C. § 1491, sustained the Commissioner's disallowances. (R. 65, 96.)

REASONS FOR GRANTING THE WRIT

I. The Decision Below With Respect to Accrual of Sales Commissions Conflicts Directly With a Decision of the Sixth Circuit and in Principle and Result With Other Decisions, Including a Decision of This Court.

The decision below with respect to accrual of sales commissions as deductions conflicts directly with the decision of the United States Court of Appeals for the Sixth Circuit in *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (6th Cir. 1942), reprinted in Appendix C, *infra,* pp. 1c-11c. It also conflicts in principle and result with several other decisions, including a decision of this Court.

It has long been a well-settled rule of accrual method tax accounting that sales commissions payable unless the purchaser defaults in his installment payments are accruable in the year of sale. *Ohmer Register Co.* v. *Commissioner, supra; Central Cuba Sugar Co.* v. *Commissioner,* 198 F. 2d 214 (2d Cir.), *cert. denied,* 344 U. S. 874 (1952); *Warren Co.,* 46 B. T. A. 897 (1942), *acq.,* 1942-2 C. B. 19, *aff'd on diff. issue,* 135 F. 2d 679 (5th Cir. 1943). This well-settled rule governs both the time of accrual of such commissions as deductions by the seller of merchandise (cases cited *supra*) and as income by an accrual-basis sales agent. *Georgia School-Book Depository, Inc.,* 1 T. C. 463

(1943); *Berryman D. Fincannon,* 2 T. C. 216 (1943). This rule of accrual applies where payment of the commission is deferred until the seller determines whether the purchaser honors his payment obligation (as in the *Central Cuba Sugar* case). It also applies where the seller pays a portion of the commission at once and, in the event of default by the purchaser, recovers the portion of the commission previously paid or charges it against other commission credits (as in the *Ohmer* and *Warren* cases).

The above cases reflect the basic concept of accrual accounting "that obligations incurred in the normal course of business will be discharged in due course." *Helvering* v. *Russian Finance & Construction Corp.,* 77 F. 2d 324, 327 (2d Cir. 1935). As this Court has said, "It is to be assumed that the whole contract between the parties will be observed, not broken." *Wells* v. *Savannah,* 181 U. S. 531, 545 (1901); *cf. United States* v. *Boston & Providence R. R.,* 37 F. 2d 670, 672 (1st Cir. 1930). There "is always the possibility that a purchaser or a debtor will default in his obligation but that contingency is not sufficient to defer the accruing of income that has been earned." *Key Homes, Inc.,* 30 T. C. 109, 113 (1958), *aff'd per curiam,* 271 F. 2d 280 (6th Cir. 1959).

Under this basic concept of accrual accounting the sales commission is no more contingent than the installment purchaser's obligation. The "fact that the agent might not, in the end receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold." *Ohmer Register Co.* v. *Commissioner, supra,* at 686. The "possibility that some of the contracts might not be finally executed," the Second Circuit held in the *Central Cuba Sugar* case, did not defeat accrual of the sales commissions. 198 F. 2d at 217. The

Board of Tax Appeals, after noting in *Warren* that some purchasers might not pay their notes, held that the taxpayer could "accrue against the . . . income items its liability to pay the agents' commissions" since that liability "was just as certain as payment of the notes was certain." 46 B. T. A. at 913. "To treat petitioner's income and deductions in [this] manner," added the Board, "is simply to treat both sides of the ledger in the same way." And the Sixth Circuit in *Ohmer,* holding also that "[b]oth sides of the ledger must be treated alike," added that, otherwise, the taxpayer would be "upon an accrual basis with respect to income and upon a cash basis with respect to expense in commissions in making sales from which the income was derived." 131 F. 2d at 686.

The Sixth Circuit, in *Ohmer* and in its earlier decision to the same effect (*Air-Way Electric Appliance Corp.* v. *Guitteau,* 123 F. 2d 20 (6th Cir. 1941)), cited and relied on the decision of this Court in *American National Co.* v. *United States,* 274 U. S. 99 (1927). The taxpayer in *American National,* a loan broker which received commissions for placing mortgage notes, agreed to pay to purchasers of mortgage notes a bonus equal to one percent per year of the principal of the note until paid. This Court held that the taxpayer could deduct as an expense of placing the note the aggregate bonus it would have to pay if the note were continued to maturity, even though the bonus was contingent on continuance of the note to maturity and the note could be prepaid without penalty. This Court reasoned that the taxpayer's "net income for the year could not have been rightly determined without deducting from the gross income represented by the commission[s] . . ., the obligations which it incurred under the bonus contracts." 274 U. S. at 105.

Although the Court of Claims reached a decision clearly at odds with the above cases, it did not openly reject them

but purported to distinguish them. (R. 60, n. 7.) The Court of Claims attempted to distinguish *Ohmer* on the ground that "in *Ohmer* each individual order (upon shipment) gave rise to liability for a commission" but in this case "a quality bonus was based not upon an individual sale, but upon the overall experience within the manager's territory within a given quarter." (R. 60-61.)

The decision of the Court of Claims is directly contrary to the *Ohmer* line of cases, for even if the purported factual distinction quoted above were correct (and we shall show that it is not), that distinction is without legal relevance to the question of accrual. Acceptance by the Court of Claims of the *Ohmer* line of cases would have meant recognition by that Court that a sales commission accrues at the time of sale even though payment of the commission is conditioned on the purchaser's making his installment payments. Yet the Court of Claims rejected exactly that principle of accrual accounting in holding that the petitioner could not accrue the $7 of quality bonuses on a sale to purchaser A because the quality bonuses might be offset by charges if some other purchaser (B or C) defaulted. Surely, performance by purchasers B and C is to be presumed to the same extent as is performance by purchaser A.

In the *Central Cuba Sugar* case the entire sales commission was deductible at the time of sale although no part of it was paid until the purchaser had performed his contract. In the *Ohmer* and *Warren* cases the taxpayers paid a portion of the commissions at once, but charged them back against other commissions if the purchaser subsequently breached. Obviously, the *Ohmer* and *Warren* commissions were just as accruable as the *Central Cuba Sugar* commissions. Payment cannot defeat an accrual if the accrual is otherwise good. Had the petitioner withheld payment of the entire $49 on each sale until the sale became bona fide, the Court of Claims, had it really accepted

the *Ohmer* line of cases, would have approved accrual of a $49 commission deduction per sale. Its diminishment of that deduction because the petitioner paid, but had the right to recover, $42 of the $49 is in direct conflict with *Ohmer* and *Warren* and violates the basic concept of accrual accounting that the Court of Claims pretends to accept.

A recent decision of this Court supports accrual of the petitioner's quality bonuses despite the possibility that they might be offset by charges with respect to other sales that might fail to become bona fide. In *Commissioner* v. *Hansen,* 360 U. S. 446 (1959), this Court rejected the argument that an automobile dealer was not taxable on funds which were retained by the finance company which purchased his installment receivables and which might thereafter be used to offset charges of the finance company against the dealer. This Court stated that funds "which are applied to the payment of [the dealer's] obligations . . . are as much 'received' by him as those which" are paid to him in cash. 360 U. S. at 465-466. By the same token, quality bonuses which are applied to payment of charges against a sales manager are as much received by him as quality bonuses paid to him in cash.

The decision below is also in direct conflict with *Ohmer* because the factual distinction that the Court of Claims purported to find is nonexistent, as is readily apparent from the sales agents' agreements in *Ohmer* (the form of which, taken from the record on appeal in the *Ohmer* case, is reproduced in Appendix C, *infra,* pp. 11c-31c. The Court of Claims emphasized that quality bonuses were based upon the number of orders that became bona fide (R. 59); that charges were made against managers for sales that failed to become bona fide and that the manager was paid the excess of credits over charges (R. 59-60); and that charges against a manager could exceed his credits (R. 60). The *Ohmer*

agreements had all of these features: Paragraph 5 of those agreements provided that commissions "shall be paid on the amount of total net sales"; Paragraph 8 provided that "in case the Company takes back the product sold or commences repossession proceedings, the commission credited on the original transaction will be charged back to Agent's commission account"; Paragraph 9 provided that the "Agent's commission account shall be debited with an amount equivalent to full rate of commission on the balance owing by customers on all accounts which become three (3) months or more past due"; Paragraph 9 of the rider to the agreements authorized the company "to deduct any amount Agent may owe the Company, or any amount charged to Agent's account, . . . when making any settlement with Agent" and required the agent "to pay Company promptly upon request the amount owing Company or charged by Company to Agent's account"; and Paragraph 30 of the agreements provided that upon termination "a statement of Agent's commission account showing commission credits, advances, charge-backs and miscellaneous debits and credits will be rendered" and that if "Agent's account shall show an indebtedness to the Company, the amount thereof shall be immediately due and payable to the Company."

Clearly, what the Court of Claims did below was to disagree with *Ohmer* rather than to distinguish it. This is also obvious from its second ground of purported distinction: "Secondly, in *Ohmer* and in plaintiff's authorities, the liability regarding which deductibility was sought had become fixed in the taxable year, and this was the basis for allowing the deduction in that year." (R. 61.) The question of whether or not the liability sought to be deducted had become fixed, and therefore accruable, in the taxable year is the question of law presented for decision in this case. What the statement quoted above means is that although the Sixth Circuit decided that question of law in favor of

accrual, the Court of Claims has now decided it the other way.

In reaching a result so clearly at odds with the *Ohmer* line of cases, the Court of Claims is sowing confusion in an important income tax area that had long been satisfactorily settled. The conflict is one that should be resolved by this Court.

II. The Decision Below With Respect to the Effect of a Violation of the Written Notice Requirement of Section 7605(b) of the Internal Revenue Code of 1954 Is in Direct Conflict With a Decision of the Seventh Circuit.

The decision below upholds the validity of a deficiency assessment resulting from a second inspection of the petitioner's books of account for the taxable year ended September 30, 1955 made in violation of the written notification requirement of section 7605(b) of the Internal Revenue Code of 1954. That decision conflicts directly with the decision of the United States Court of Appeals for the Seventh Circuit in *Reineman* v. *United States*, 301 F. 2d 267 (7th Cir. 1962), reprinted in Appendix D, *infra*, pp. 1d-10d.

Section 7605(b) contains two distinct prohibitions, the second of which was violated in this case. The violated prohibition is that "only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary." Congress enacted this requirement of responsible preliminary investigation and written notice to meet "simply and fully" a "recognized . . . need for a curb on the investigating powers of low-echelon revenue agents . . . by requiring such agents to clear any repetitive examination with a superior."

United States v. *Powell*, 379 U. S. 48, 55-56 (1964). The requirement was intended by Congress as "a safeguard against oppressive action by subordinate officials." *Pacific Mills* v. *Kenefick*, 99 F. 2d 188, 189 (1st Cir. 1938). The purpose was "to curb excessive administration zeal." *O'Connor* v. *O'Connell*, 253 F. 2d 365, 369 (1st Cir. 1958).

The command of section 7605(b) with respect to written notice is unequivocal; the command is one which the Commissioner of Internal Revenue must observe. This Court stated, in *United States* v. *Powell, supra*, at 57-58, after a full review of the legislative history of section 7605(b), that to obtain enforcement of an administrative summons for a second production of books of account for a taxable year, the Commissioner "must show . . . that the administrative steps required by the Code have been followed—in particular, that the 'Secretary or his delegate,' after investigation, has determined the further examination to be necessary and has notified the taxpayer in writing to that effect."*

In the *Reineman* case an Internal Revenue agent assigned to audit the taxpayer's 1955 return had made a second inspection of the taxpayer's books of account for 1954 in violation of the prior written notice requirement. The unauthorized second inspection resulted in assessment of a 1954 deficiency, which the taxpayer contested. The Seventh Circuit set the assessment aside because of the failure of the Commissioner to comply with the notice requirement. Unless this was done, the Seventh Circuit noted, the taxpayer would have been "left without any remedy to

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*Several Courts of Appeals had earlier expressed this view. *Holmquist* v. *Blair*, 35 F. 2d 10, 13 (8th Cir. 1929); *Pacific Mills* v. *Kenefick, supra*, at 190; *De Masters* v. *Arend*, 313 F. 2d 79, 86 (9th Cir.), *petition for cert. dismissed pursuant to Rule 60*, 375 U. S. 936 (1963); *United States* v. *Ryan*, 320 F. 2d 500, 503 (6th Cir. 1963), *aff'd on diff. issue*, 379 U. S. 61 (1964).

correct the illegal action taken by the Commissioner." 301 F. 2d at 272.

In the decision below the Court of Claims held that "the failure of the Government to comply with section 7605(b) had no effect upon the validity of the deficiency assessment for fiscal 1955." (R. 65.) This holding is inescapably in conflict with *Reineman,* which the Court of Claims cited (R. 63) but did not even attempt to distinguish.

This case and *Reineman* involved clear violations of the prior written notice requirement of section 7605(b) under strikingly similar circumstances. In both cases an Internal Revenue agent had inspected the taxpayer's books of account for the taxable year he had been assigned to audit and a resulting deficiency had been assessed and paid. (*Compare* 301 F. 2d at 269 *with* R. 85, 87.) In both cases another Internal Revenue agent assigned to audit the succeeding taxable year had, without disclosing his intention to the taxpayer, made a second inspection of the taxpayer's books of account for the prior taxable year for the purpose of setting up an additional deficiency. (*Compare* 301 F. 2d at 269 *with* R. 88-91.) Neither taxpayer requested the second inspection and in neither case was the prior written notice requirement complied with. (*Compare* 301 F. 2d at 269 *with* R. 90.) Since both taxpayers objected at the earliest opportunity, there was no waiver of the notice requirement in either case. (*Compare* 301 F. 2d at 271 *with* R. 89, 90.) In neither case did the taxpayer have, in the words of the Seventh Circuit, any "opportunity for self-help," for the second Internal Revenue agent "never made any pretense that his assignment was to reopen the [prior] year." (*Compare* 301 F. 2d at 271 *with* R. 88, 91.) The additional assessments in both cases were based on information which was obtained from the illegally inspected books of account and which could not have been obtained

from any other source. (*Compare* 301 F. 2d at 270-271 *with* R. 89, 91, 92.) Here, as in *Reineman*, the taxpayer is "left without any remedy to correct the illegal action taken by the Commissioner unless the deficiency assessment is set aside." 301 F. 2d at 272.

The Seventh Circuit does not stand alone in protecting taxpayers against violations of the written notice requirement of section 7605(b) by denying to the Commissioner the benefits of the illegal action. Where no such notice was given the taxpayer successfully moved to vacate an order requiring him to appear, give testimony and produce records. *In re Paramount Jewelry Co., Inc.*, 80 F. Supp. 375 (S. D. N. Y. 1948). See *United States* v. *Ryan, supra,* at 503. Taxpayers have also successfully moved to suppress evidence obtained in inspections made in disregard of the notice requirement. *Application of Leonardo,* 208 F. Supp. 124 (N. D. Calif. 1962); *United States* v. *Avila,* 227 F. Supp. 3 (N. D. Calif. 1963).

Unless the courts protect taxpayers from such violations by depriving the Commissioner of the fruits thereof, "§ 7605(b) would be relegated to hardly more than a pious exhortation directed to the tax authorities." *O'Connor* v. *O'Connell, supra,* at 370. The only alternative to invalidation of a deficiency arising from an unauthorized reexamination "is no sanction at all." *Wolf* v. *Colorado,* 338 U. S. 25, 41 (1949) (Murphy, J., dissenting). Under the decision below, the petitioner has a right but no remedy and the second prohibition of section 7605(b) becomes a nullity.

The conflict between this case and *Reineman* presents the important question of whether the Commissioner may intrude into taxpayers' affairs in disregard of the procedural safeguard provided by Congress. Review by this Court is necessary to resolve this question.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 11, 1965.

APPENDIX A

Opinion, Findings of Fact and Conclusion of Law of The United States Court of Claims

In the United States Court of Claims

No. 13–60

(Decided July 16, 1965)

FIELD ENTERPRISES, INC. v. THE UNITED STATES

James B. Lewis, attorney of record, for plaintiff. *Alan N. Cohen*, *Richard H. Paul*, *Michael J. Nassau*, and *Paul, Weiss, Rifkind, Wharton & Garrison*, of counsel.

David D. Rosenstein, with whom was *Assistant Attorney General Louis F. Oberdorfer*, for defendant. *C. Moxley Featherston*, *Lyle M. Turner*, and *Philip R. Miller*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS and COLLINS, *Judges*.

OPINION

COLLINS, *Judge*, delivered the opinion of the court:

In this action, plaintiff seeks the refund of alleged overpayments of income tax for its fiscal years which ended September 30, 1955, and September 30, 1956, respectively. The total of the alleged overpayments (including interest) is $476,037.65.

Among plaintiff's business activities were the publication and sale of the World Book Encyclopedia.[1] Marketing was accomplished by plaintiff's vast sales organization which relied upon personal solicitation. More than 80 percent of the purchases were made under the installment plan.

[1] Another set of books published and sold by plaintiff was Childcraft. The legal issues regarding World Book and Childcraft are the same. For the sake of brevity, the examples and references in this opinion will be limited to World Book.

This case arises out of a dispute between plaintiff, an accrual-basis taxpayer, and the Commissioner of Internal Revenue over the proper year for the deduction of "quality bonuses," a portion of the compensation paid to plaintiff's sales managers. Effective October 1, 1954 (the beginning of plaintiff's 1955 fiscal year), plaintiff altered its system for compensating sales personnel. Previous to October 1, 1954, all of plaintiff's sales force, managers as well as salesmen, were paid by means of commissions.[2] However, the revised system introduced a new element, the "quality bonus," which managers [3] would receive in addition to specified commissions. There is no dispute as to plaintiff's tax treatment of the commissions, but the basic issue in the present controversy is the proper time for deduction of quality bonuses.

Determination of quality bonuses was accomplished on the basis of 3-month periods. The size of the quality bonus which a particular manager would receive depended upon the number of approved orders taken in his territory which became "bona fide." The test of "bonafication" was met if the purchaser accepted delivery and paid, within 6 months, an amount equal to the down payment plus two installment payments. Findings 17(b) and 23, *infra*. For each order which did not become bona fide, the manager's account would be charged an amount equal to the sum of the commissions paid to the manager and to certain of his subordinates. Thus, depending upon the number of orders which failed to become bona fide, it was possible that the charges against a manager would exceed his potential quality-bonus credits.[4] For example, with regard to a district manager, his potential quality bonus for a certain edition of World Book was $3 per set. However, for each order which did not become bona fide, a charge in the amount of $36 would be made against the manager's account. For a detailed illustration of this system, see finding 27, *infra*.

With respect to each of the taxable years in issue, the amount of the quality bonus which plaintiff accrued on its

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[2] For a detailed discussion of the former (i.e., pre-October 1954) system and plaintiff's method of accounting therefor, see findings 14–16, *infra*.

[3] Actually, plaintiff had several levels of managers. Finding 6(b), *infra*. Although the amount of compensation varied from level to level, the same basic principles applied to each category of managers. Finding 17, *infra*.

[4] With regard to the consequences of a deficit in a manager's quality-bonus account, see finding 28, *infra*. See also findings 18 and 27(b), *infra*.

books and included in its deduction for "salaries and wages" was determined in the following manner: First, plaintiff computed the total amount of potential quality bonuses which had been credited, during the year, to the accounts of the managers. Secondly, regarding the months which had ended at least 6 months prior to the close of the fiscal year, plaintiff could ascertain the exact amount of its liability for quality bonuses, since all sales made during those months either had or had not become bona fide. Thus, plaintiff knew the actual amount of charges made against the managers. Thirdly, with respect to the remaining months, it was not possible to determine plaintiff's exact liability for quality bonuses. Therefore, plaintiff, on the basis of its past experience, estimated the number of orders accepted during the latter half of the year which would, in the future, fail to become bona fide. In this way, plaintiff made an estimate of the amount which would eventually be charged against the managers. Fourthly and finally, plaintiff subtracted from the total amount of potential quality-bonus credits (1) the actual charges against the managers for the first half of the year and (2) the estimate, relating to sales made in the second half, of future charges against the managers. The resulting amount was included as a deduction on plaintiff's income tax returns. Finding 33, *infra*.

Basically, plaintiff's contentions are that the deductions so determined for the respective years were proper and that plaintiff's accounting method "clearly reflected" its income.[5] The Commissioner of Internal Revenue, on the other hand, disallowed plaintiff's deductions in part, refusing to permit the deduction for quality bonuses attributable to orders taken during quality-bonus quarters which ended during the last 6 months of the fiscal year. Finding 52, *infra*. The position of the Government is that plaintiff's liability for the quality bonuses was *contingent* until the "bonafication" period of 6 months had expired with respect to all orders accepted during the quarter and that, so long as such liability remained contingent, no deduction for it was proper.

The test pertaining to the proper year for deductions by an accrual-basis taxpayer is contained in Treas. Reg. § 1.461–1(a)(2) and is as follows:

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[5] See Int. Rev. Code of 1954, § 446.

> Under an accrual method of accounting, an expense is deductible for the taxable year in which *all the events have occurred which determine the fact of the liability* and the amount thereof can be determined with reasonable accuracy. * * * (Emphasis supplied.)

Cf. United States v. *Anderson*, 269 U.S. 422 (1926). In the instant case, the Commissioner of Internal Revenue properly concluded that, with respect to quality bonuses attributable to sales made during a given quarter, the "all events" test was not satisfied until a period of 6 months had elapsed after the end of the quarter.

Of prime significance are the terms of the contract entered into by plaintiff and each of its managers and the corresponding practice regarding quality bonuses. The pertinent contractual provisions, which are set forth in finding 17(b), *infra*, demonstrate the validity of defendant's contention that a manager had no right to a quality bonus on an individual order. Rather, entitlement to a quality bonus depended upon the experience regarding *all* orders taken in the manager's territory during a particular quarter. Upon the acceptance by plaintiff of an order, the manager received a "potential quality bonus credit." However, the credit was potential in fact as well as in name, and the credit did not represent an *actual* liability of plaintiff.

According to the contract, a manager's quality bonus was "based upon the number of accepted orders taken in * * * [his] territory which * * * [became] bona fide." Before plaintiff's obligation to pay a quality bonus came into being, it was essential to determine the number of sales which had met the test of "bonafication," and no such determination could be made until the 6-month period had ended. As defendant points out, an integral part of the quality-bonus system was the provision that charges would be made against a manager's account for each order which failed to become bona fide.[6] The contract defined "the amount of quality

[6] The managerial contract also provided for the possibility that charges against a manager for supplies and other expenses would be recovered from "quality bonus payments or other amounts due the manager." Finding 17(b) *infra*. This provision, unlike that regarding charges for orders which did not become bona fide, was not an actual element in determining the manager's quality bonus. To the contrary, the liability for supplies, etc., was totally unrelated to the quality-bonus system.

bonus due * * * [a manager for a quarter]" as the "excess of credits over charges * * *." As indicated previously, it was possible that a manager's charges could be greater than his credits.

Plaintiff's practice regarding quality bonuses was in accord with the provisions of the managerial contracts. Clearly, the basic feature of the quality-bonus system was the matter of "bonafication." In the opinion of this court, the Commissioner of Internal Revenue properly concluded that plaintiff's liability for quality bonuses for a given quarter was not fixed until the "bonafication" period of 6 months had elapsed.

Plaintiff asserts that the fixing of its liability for a quality bonus was not deferred, but took place upon the acceptance of the order. In support of its contention, plaintiff cites a number of cases, including *Ohmer Register Co.* v. *Comm'r* 131 F. 2d 682 (6th Cir. 1942).[7] The compensation of Ohmer's sales agents included a collection commission which was payable after Ohmer received the balance of the sales price from the customer. The Commissioner of Internal Revenue denied the right of Ohmer, an accrual-basis taxpayer, to deduct for 1936 a "reserve" representing liability for collection commissions attributable to the sales during that year. In holding that the deduction should be permitted, the court rejected the assertion that Ohmer's liability was "contingent." The court concluded that the commissions constituted a definite obligation at the time of shipment. Since Ohmer used the accrual method, the possibility "that the agent might not, in the end receive his full commission * * * [was] no more material than that * * * [Ohmer] might not receive full payment * * *." 131 F. 2d at 686.

According to plaintiff, the quality bonuses are analagous to the commissions involved in *Ohmer Register Co.*, *supra*, but we do not agree. One factual difference is that, in *Ohmer*, each individual order (upon shipment) gave rise to

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[7] Other cases cited by plaintiff with regard to the proper time for deductions by an accrual-basis taxpayer include the following: *American National Co.* v. *United States*, 274 U.S. 99 (1927); *United States* v. *Anderson*, *supra*; *Central Cuba Sugar Co.* v. *Comm'r*, 198 F. 2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); *Air-Way Elec. Appliance Corp.* v. *Guitteau*, 123 F. 2d 20 (6th Cir. 1941); and *Warren Co.* v. *Comm'r*, 46 B.T.A. 897 (1942), *acq.*, 1942-2 Cum. Bull. 19, *aff'd regarding different issue*, 135 F. 2d 679 (5th Cir. 1943).

For reasons explained above, each of the decisions cited by plaintiff is materially distinguishable from the instant case.

liability for a commission. With regard to the case at bar, we have already indicated that a quality bonus was based not upon an individual sale, but upon the overall experience within the manager's territory for a given quarter. Secondly, in *Ohmer* and in plaintiff's other authorities, the liability regarding which deductibility was sought had become fixed in the taxable year, and this was the basis for allowing the deduction in that year. *E.g.*, *Helvering* v. *Russian Fin. & Constr. Corp.*, 77 F. 2d 324, 327 (2d Cir. 1935). In other words, the "all events" test had been met, even though, in some instances, the liability was subject to a "condition subsequent" (for example, the possibility of default by the purchaser). *Cf. Central Cuba Sugar Co.* v. *Comm'r*, *supra* note 7, at 217.

With regard to the quality bonus, our decision is not limited to a holding that *payment* of the bonus was conditional upon satisfaction of the test of "bonafication."[8] Instead, this court has concluded that no fixed liability on the part of plaintiff arose, regarding sales made in a particular quarter, until 6 months after the end of the quarter. In view of this conclusion, the notion that both sides of the ledger (*i.e.*, income and expense) must be treated alike is not controlling. Plaintiff did accrue as income the full price of all sales made during the taxable year, subject to reduction in the amount of an addition to the reserve for bad debts. Findings 29 and 30, *infra*. However, because of the nature of the quality bonus, plaintiff's accrual of the income is not determinative of the issue of the proper year for deductibility.

Subsection 446(a) of the Internal Revenue Code of 1954 provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, one exception to the above general rule is as follows:

> * * * if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary * * * does clearly reflect income. [§ 446(b).]

[8] The quality bonus due a manager for a particular quarter was paid between 7 and 8 months after the end of the quarter. Finding 28, *infra*.

The manner in which plaintiff kept its books, including plaintiff's treatment of quality bonuses, was in accord with accepted principles of accounting. Finding 56, *infra*. However, a similar finding was made in *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961), and there the majority opinion pointed out that such a finding was not the same as a holding "that for income tax purposes it [the accounting method] so clearly reflects income as to be binding on the Treasury." 367 U.S. at 693.

In *American Automobile Ass'n* v. *United States*, *supra*, at 698, the majority of the Court upheld, as a proper exercise of discretion, the rejection by the Commissioner of Internal Revenue of the taxpayer's accounting system.[9] Similarly, in the instant case, we view as the permissible exercise of discretion the Commissioner's disallowance of the deductions and his treatment of the quality bonuses. When, as here, the liability for a certain expense is not fixed in the taxable year, the Commissioner need not permit the deduction of an amount representing an estimate of that liability. *Cf. Brown* v. *Helvering*, 291 U.S. 193, 201–03 (1934).[10]

An alternative argument of defendant is that plaintiff had, without obtaining the consent of the Commissioner of Internal Revenue, made a change in its accounting for "compensation." In view of our conclusion regarding the nature of the quality bonus, discussion of defendant's alternative

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[9] Subsequent to the decision in *American Automobile Ass'n* v. *United States*, *supra*, § 456 was added to the Internal Revenue Code of 1954. This section provides, in effect, that a taxpayer may elect to treat prepaid dues income in a manner like that utilized by the taxpayer in *American Automobile Ass'n*.

The holding of *American Automobile Ass'n* was followed by the majority in *Schlude* v. *Comm'r*, 372 U.S. 128 (1963). Both of these cases involved the attempted deferral of income. See also *Parkchester Beach Club Corp.* v. *Comm'r*, 335 F. 2d 478 (2d Cir. 1964). However, the same principles apply to the treatment of estimated future expenses. *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 293 F. 2d 628 (7th Cir. 1961), *cert. denied*, 368 U.S. 976 (1962); *Simplified Tax Records, Inc.*, 41 T.C. 75, 79 (1963).

[10] The taxpayer in *Brown* v. *Helvering*, *supra*, was a general agent for fire insurance companies. For each policy written, Brown received an "overriding commission." In the event of cancellation by the policyholder, Brown was required to make a refund of the overriding commission received for that policy. Brown, an accrual-basis taxpayer, deducted from accrued commissions for the year an estimate of the amount of such commissions which would be refunded in future years. The Court upheld disallowance of the deduction. 291 U.S. at 203. Until the year when cancellation occurred, the liability to make refunds was contingent.

Brown v. *Helvering* is relevant to the instant case, for both involve the attempted deduction of liabilities which had not become fixed.

contention is unnecessary. However, mention must be given to the related assertion of plaintiff that the Government violated section 7605(b) of the Internal Revenue Code of 1954.[11] According to plaintiff, the inspection of plaintiff's books for fiscal 1955 which Revenue Agent Mortenson made in 1958 was illegal, since it constituted a second examination regarding that year and it had been made without written notice from the Commissioner of Internal Revenue.

The factual circumstances regarding the examination of plaintiff's records are set out in detail in findings 41–54, *infra*. We will assume, for the sake of argument, that Revenue Agent Mortenson's activities amounted to an inspection of plaintiff's books for fiscal 1955. The question, then, is what consequence should attach to the failure of the Commissioner of Internal Revenue to provide plaintiff with prior written notice.

Plaintiff cites *Reineman* v. *United States*, 301 F. 2d 267 (7th Cir. 1962), in which the court (1) determined that section 7605(b) had been violated and (2) held that, because of the impropriety of the second inspection, the resulting deficiency assessment was invalid.[12] In the opinion of this court, there is no warrant for extending the result reached in *Reineman* to the present case.

Previously, this court construed a provision identical to section 7605(b). *Philip Mangone Co.* v. *United States*, 73 Ct. Cl. 239, 54 F. 2d 168 (1931). The taxpayer in *Mangone* allowed (under protest) the reinspection of its books for the year in question. After noting that the taxpayer should have refused access to its records until proper notice was given, this court stated: "Aside from all this, however, we can not hold that a deficiency assessment is illegal when the facts upon which it was based were ascertained in the way

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[11] Int. Rev. Code of 1954, § 7605(b), provides as follows:

"* * * No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."

[12] Also cited by plaintiff is *Application of Leonardo*, 208 F. Supp. 124 (N.D. Cal. 1962), an action in which the taxpayer sought to suppress the use, as the basis for criminal prosecution, of evidence obtained allegedly in violation of § 7605(b). The court granted the relief requested. 208 F. Supp. at 127. Whether or not the decision in *Leonardo* was correct, the considerations which prompted that result are not applicable to the case at bar.

and manner proven." 73 Ct. Cl. at 246. In addition, the opinion in *Mangone* quoted with approval the following language from *J. S. McDonnell*, 6 B.T.A. 685, 691 (1927):

> * * * However, that section of the statute [§ 1005 of the Revenue Act of 1924] merely provides for the relief from unnecessary examinations of a taxpayer's books and does not propose to provide that any deficiency resulting from such investigation shall be void. * * *

We consider the conclusion reached in *Philip Mangone Co., supra*, to be the proper one. The facts of the present case differ from those in *Mangone*, but, in view of our interpretation of section 7605(b), the outcome must be the same. As indicated above, the holding in *Mangone* was not limited to a determination that the taxpayer had waived its rights. *Cf.* concurring opinion in *M. O. Rife, Jr.*, 41 T.C. 732, 751–2 (1964).[13] At the very least, *Mangone* stands for the proposition that not every infraction of the notice requirement calls for nullification of the deficiency assessment.

Applying the rationale of *Mangone* to the present case, we hold that, despite the questionable nature of Revenue Agent Mortenson's conduct (the secretiveness of her intent and purpose regarding the 1955 records), the deficiency assessment must stand. For a variety of reasons, some of which were the responsibility of plaintiff, Revenue Agent

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[13] In *M. O. Rife, Jr., supra*, the majority of the Tax Court held that the taxpayers had waived their objection to the second examination. The majority stated, at 747: "If a second examination is made with the knowledge of the taxpayer who raises no objection thereto, such taxpayer has waived the requirement of written notice even though respondent [the Commissioner] uses the information he obtains for a purpose not anticipated by such taxpayer at the time the second examination was made." Thus, *Reiseman, supra*, and *Leonardo, supra*, were distinguished. However, a concurring opinion, joined in by five judges, went further and stated that:

"* * * the failure of the Commissioner to comply with the provisions of section 7605(b) * * * does not invalidate the deficiency determined. I would reach this decision with all due respect for, but notwithstanding the opinion of the Court of Appeals for the Seventh Circuit in *Reiseman* v. *United States* * * * [*supra*], which stands alone in this field in the face of numerous judicial statements pointing the other way.

"In my opinion * * * nothing in the language of section 7605(b) or in the legislative history * * * requires a contrary holding. As this and other courts have repeatedly stated, that section of the statute (and its predecessors * * *) merely provides for the relief of a taxpayer from unnecessary and repeated examinations of his books and records such as he might otherwise be subjected to under the provisions of sections 7602, 7603, and 7604. [Citations omitted.]"

For a discussion of the legislative history of § 7605(b), see *United States* v. *Powell*, 379 U.S. 48, 54 (1964).

Harlor, the agent who first examined plaintiff's 1955 records, did not actually learn of the existence of the quality-bonus system. Findings 16(b) and 43–45, *infra*. On the other hand, Agent Mortenson's use of plaintiff's 1955 records was limited primarily to her inspection regarding the quality bonuses. In this sense, it cannot be said that plaintiff was subjected to "unnecessary examination." Furthermore, without regard to plaintiff's subjective intent, plaintiff did voluntarily furnish to Agent Mortenson its 1955 records. *Cf. M. O. Rife, Jr.*, *supra*, at 747.

Therefore, we conclude that, in this case, the failure of the Government to comply with section 7605(b) had no effect upon the validity of the deficiency assessment for fiscal 1955. As stated previously, we hold that the actions of the Commissioner of Internal Revenue with regard to plaintiff's deduction of quality bonuses constituted the proper exercise of discretion. Accordingly, plaintiff is not entitled to recover and the petition is dismissed.

FINDINGS OF FACT

The court, having considered the evidence, the report of Trial Commissioner Franklin M. Stone, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff (hereinafter sometimes referred to as the "taxpayer"), a Delaware corporation, has its principal place of business in Chicago, Illinois.

2. Throughout its existence, plaintiff has used the accrual method of accounting and has kept its books and filed its income tax returns on the basis of a fiscal year ending September 30. Plaintiff filed its federal income tax returns for the fiscal years ended September 30, 1955, and September 30, 1956, within the time required by law, with the District Director of Internal Revenue, Chicago, Illinois, and paid the taxes of $974,179 and $3,323,955, respectively, thereon shown to be due.

3. Prior to and during the fiscal years ended September 30, 1955, and September 30, 1956, plaintiff was engaged, among other business activities, in the publication and sale of the World Book Encyclopedia (hereinafter referred to as "World Book"), a 19-volume general encyclopedia, and

"Childcraft," a 15-volume set of books on child development. Plaintiff, through its Educational Division, published and sold World Book in three differently priced bindings (white, red, and blue) and Childcraft in two differently priced bindings (orange and blue).

4. During the 2 fiscal years (1955 and 1956) here in issue, plaintiff offered World Book and Childcraft for sale either for cash or under various installment purchase plans. Over 80 percent of the sales were made under installment purchase plans. Plaintiff charged somewhat lower prices for World Book and Childcraft to purchasers who paid cash than to purchasers who paid in installments. Whether a sale was at the cash sales price, or at the installment sales price, depended on whether the purchaser completed payment within 60 days following the date of the purchase order. Sales prices during this period were as follows:

	World Book			Childcraft	
	White	Red	Blue	Orange	Blue
Cash	$160.00	$134.00	$105.00	$76.80	$66.80
Installments	169.00	129.00	109.00	79.80	69.80

5. Plaintiff's sales of World Book and Childcraft were made primarily through personal solicitation by members of its nationwide sales organization which, during the period here involved, consisted of between 20,000 and 25,000 active salesmen, a large portion of whom were employed on a part-time basis.

6. (a) During the 2-year (1955–56) period in issue, plaintiff maintained separate sales organizations for World Book and Childcraft. Plaintiff generally divided its United States sales territory into geographical divisions and subdivided each division into regions, each region into districts, and each district into areas.

(b) Each of plaintiff's divisions was headed by either a senior division manager or a division manager. Each region was headed by a regional manager. Each district was headed by a district manager and each area by an area manager.

Under the supervision of an area manager were full-time and part-time salesmen (hereinafter sometimes referred to as "representatives"), who were further classed by grade.

(c) The above-described organizational structure was not fully established in every part of the country, as sometimes one or more of the managerial levels was omitted.

7. Approximately 1,000 members of plaintiff's sales force were senior division managers, division managers, regional managers, or district managers. (Such sales personnel are hereinafter collectively called "managers," and sales personnel below the level of district manager are hereinafter collectively called "salesmen.") The duties of the managers were to hire salesmen, train, and supervise them.

8. Persons desiring to purchase World Book or Childcraft were required to execute and sign noncancelable purchase orders. Plaintiff, on receiving purchase orders in its principal office, checked them as to accuracy, terms, and credit standing, and accepted the order if satisfactory.

9. Although these purchase orders were by their express terms noncancelable, plaintiff, as a matter of actual practice, treated as a sales return (sometimes called a countermanded order) refusal by the purchaser to accept delivery of the books, notice of cancellation by the purchaser within 30 days following acceptance of the order, or return by the bank of the purchaser's down payment check as uncollectible. In such cases, plaintiff attempted to find out why the order had been countermanded; and if the purchaser had a complaint and would not accept the books, plaintiff did not make a legal attempt to force acceptance.

10. (a) The lowest installment terms allowed by plaintiff for World Book were (i) prior to June 1, 1953, a down payment of $10 and installment payments of $6 a month; (ii) from June 1, 1953, through March 31, 1954, a down payment of $10 and installment payments of $10 a month; (iii) from April 1, 1954, through April 30, 1955, a down payment of $10 and installment payments of $6 a month for the red and blue binding, and a down payment of $10 and installment payments of $10 a month for the white binding; and beginning May 1, 1955, a down payment of $10 and installment payments of $6 a month for all bindings.

(b) The lowest installment terms allowed by plaintiff for Childcraft were a down payment of $5 and installment payments of $5 a month.

11. For the fiscal year ended September 30, 1955, plaintiff sold 237,351 sets of World Book and Childcraft, resulting in net sales of $28,488,691. For the fiscal year ended September 30, 1956, plaintiff sold 283,638 sets of such publications, resulting in net sales of $35,343,880. Plaintiff's outstanding installment receivables from purchasers of World Book and Childcraft, as of the close of each of the taxable years, 1953 to 1956, inclusive, were as follows:

	1953	1954	1955	1956
Approximate number of accounts receivable	243,400	213,800	268,600	304,000
Dollar balance	$15,976,617	$14,330,248	$18,696,977	$24,580,553
Average balance per account	$65.64	$67.03	$75.21	$80.86

12. Throughout the entire period, both prior to and during the 2 taxable years here in issue, plaintiff and its sales managers and salesmen had written contracts which described the relationship between them. With minor exceptions, the contracts were closely adhered to in the conduct of plaintiff's business.

13. As of October 1, 1954, the contracts which had been in effect between plaintiff's sales managers and salesmen (hereinafter called "old contracts") were terminated, and plaintiff entered into new contracts with its sales personnel.

14. Under the old contracts, both managers and salesmen were compensated by means of commissions. Regarding each "bona fide" sale, the pertinent sales personnel were credited with their commissions. An order for an encyclopedia set became "bona fide" when the purchaser had accepted delivery and had paid, within 15 months of the order, the amount of $30. The old contracts provided that plaintiff would make certain advances against commissions.

15. The commission structure under the old contracts is illustrated by the following table showing commissions for a sale of World Book in the red binding made by the lowest level salesman under the supervision of an area manager,

district manager, and senior division manager, and the advance on such commissions:

Sales level	Commission	Advance
Salesman	$24.00	$20.00
Area Manager	6.00	5.00
District Manager	6.00	4.00
Senior Division Manager	12.00	10.00
Total	48.00	39.00

The senior division manager received, in addition to the amount set forth above, an office allowance of $1 on each bona fide order.

16. (a) Under the old contracts, plaintiff maintained for each taxable year a commission account for each manager and salesman. In brief, this account was charged with advances paid to the manager or salesman on sales made during the taxable year, and it was credited with commissions of such sales which became bona fide. After the end of the taxable year, plaintiff paid to the manager or salesman the excess, if any, of the credits to his commission account over the charges thereto.

(b) The accounting books of plaintiff and its federal income tax returns differed in the treatment which was accorded to plaintiff's liability for commissions. In a document prepared by plaintiff and furnished to Revenue Agent Thomas B. Harlor, this difference in treatment was explained as follows:

> In its Federal income tax return for the fiscal year ended September 30, 1955, the company reflected the amount of $2,751,188.00 in Schedule M, in which taxable income is reconciled to book income. This item, representing a decrease from book income, was labeled "charges to accrued commissions in excess of provision." A comprehensive explanation of this item has been requested.
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> Since inception, for book purposes, the company has consistently followed the practice of recognizing its expected liability to a sales representative as of the time the sales order taken by the representative was accepted in the home office. For tax purposes, however, recognizing that the commission might never actually become a lia-

bility because of a requirement that a certain amount of the sales price be collected before the commission would be credited and made unconditionally payable to the representative, the company has claimed deductions for commissions only as a definite liability to pay is incurred.

The company's essential book accounting for commissions can be illustrated as follows:

Dr.: Commission expense
Cr.: Accrued commissions
(To record commission on acceptance of order.)
Dr.: Accrued commissions
Cr.: Commission payable (representative X)
(To record the earning of commission on sale and liability to pay to representative.)

As of the close of each taxable year, the company ascertained the amount by which the credits during the year to the accrued commission account (representing expected, but not actual liability) were greater or less than debits to the account (representing earned commissions becoming a legal liability). Income for tax purposes was increased in the years when credits exceeded the debits and decreased in years in which the debits exceeded the credits. The effect of this procedure was to limit deductions for sales commissions in each year to such amounts as were actually earned by and legally payable to the sales representatives.

Increases and decreases in income for tax purposes were as follows in recent years with respect to this item:

* * * * *

For years after fiscal 1956 commission expense will be the same for book and tax purposes. The reason for this and for the large item in fiscal 1955 is discussed below.

For many years the aforementioned commissions on sales did not become legally enforceable obligations of the company until certain minimum portions of the sales price were received from the customer. For example, in the case of World Book Encyclopedia (red binding) the commission of $24.00 was earned at such time as $30.00 of the total selling price of $129.00 was received by the company. The collection of $30.00 made the sale "bona fide" and such bonafication was essential to the representative's entitlement to the commission.

Bonafication prior to the crediting of commissions was considered necessary in order to avoid the possibility that a commission of $24.00 would be credited and paid when the purchaser of the encyclopedia had paid a lesser amount as a down-payment and made no further payments. Experience over the years indicated that only

about 10% of all accepted orders failed to become bona fide.

The maintenance of records to control the bonafication of orders was time-consuming and very costly. With the knowledge that about 90% of all orders became bona fide, the company determined that substantial clerical and administrative costs could be eliminated by dispensing with the requirement for bonafication. New contracts entered into during the fiscal year ended September 30, 1955 provide that commissions are due and payable at the time the sales orders are accepted. To compensate for the average loss of about 10%, the commission above mentioned was reduced from $24.00 to $22.00. As a consequence of the foregoing, there were charges to the accrued commission account during the fiscal year ended September 30, 1955 aggregating $2,751,188.00, representing amounts which became payable during the year and deductible for tax purposes. There were no credits to the former accrued commission account, as in prior years, since current commissions became a liability at the date of sale. Taxable income accordingly was decreased in that amount in accordance with the established accounting methods. During the fiscal year ended September 30, 1956, charges to the account in the amount of $6,154.00, reflected in Schedule M of Form 1120 for that year, exhausted the balance in the account, and for subsequent years book and tax income are identical as respects this item.

17. (a) Under the terms of the new contracts, effective as of October 1, 1954, the compensation of plaintiff's salesmen was treated differently from that of its managers. Salesmen were compensated exclusively by means of weekly commissions. Managers were compensated in part by means of weekly commissions. Salesmen were paid a commission contingent only on the acceptance of the order by the plaintiff.

(b) The compensation of managers was divided into a commission, payable weekly, and a "quality bonus," payable quarterly. The new contracts for managers provided, in part, as follows:

2. COMPENSATION OF MANAGER:

A. *Commissions:* (1) The MANAGER shall be paid weekly a commission on each order for immediate delivery which is taken in the territory assigned to him (including orders taken by him or by anyone in his sales organization) and is accepted by the COMPANY. * * *

(2) The MANAGER shall be paid weekly an additional commission for each accepted parent or teacher order obtained personally by him and accompanied by cash in full or a substantial down payment. * * *

B. Commissions paid on countermanded orders shall be deducted from, and commissions payable on reinstated orders added to, commissions payable on other accepted orders. An order shall be considered countermanded if the subscriber refuses to accept delivery, or requests cancellation within 30 days from the date upon which the order is accepted at the COMPANY's home office, or if the subscriber's check for the down payment is returned unpaid by his bank. A countermanded order shall be considered reinstated when the subscriber accepts delivery and subsequently makes at least his first monthly payment.

C. *Quality Bonus:* In addition to commissions, the COMPANY shall pay the MANAGER a bonus, hereinafter called "quality bonus," based upon the number of accepted orders taken in the MANAGER's territory which become bona fide. An order becomes bona fide when the subscriber has accepted delivery and has paid the COMPANY the following amount per set, or such other sum as the COMPANY may from time to time specify, within six months from the date the order was accepted by the COMPANY:

The Aristocrat	$30.00
President Red	22.00
Library Blue	22.00

[The amount specified in the Childcraft contracts for both of the bindings available for this set was $15.]

(1) The COMPANY shall establish quality bonus periods, which shall run continuously and which shall be three months in duration, or such shorter time as the COMPANY, at its option, may fix.

(2) At the expiration of six months from the end of each quality bonus period, the MANAGER shall receive the following quality bonus credit per set (based upon full selling prices now in effect) for each order which is taken in his territory during the bonus period and which has become bona fide, less quality bonus credits of any subordinate managers on such orders: [At this point the amount of the bonus credit was set forth.]

* * * * *

At the same time the MANAGER shall be charged with the following commissions and office allowances paid on orders which were accepted during the quality bonus

period from his territory but which have not become bona fide:

(a) Commissions and office allowances paid to the MANAGER; and

(b) Commissions paid to all of the MANAGER's subordinates, except district managers and their subordinates;

provided that the commission so charged against the MANAGER shall not include commissions previously recovered by the COMPANY on unreinstated countermanded orders.

(3) The excess of credits over charges for a quality bonus period shall be the amount of quality bonus due the MANAGER for that period. In the event that the charges exceed the credits, such excess of charges shall be recovered from future quality bonuses due the MANAGER.

(4) If a subordinate manager has incurred an excess of charges over credits for a quality bonus period, such excess shall be deducted from the quality bonus due the MANAGER. When such excess of charges is recovered from future quality bonuses of the subordinate manager, the amount recovered shall be added to the quality bonus due the MANAGER.

(5) Payment of the quality bonus shall be made within eight months after the quality bonus period ends.

* * * * *

E. Except as otherwise provided in this agreement, all bonuses, advances on drawing account, or other remuneration, paid by the COMPANY to anyone in the MANAGER's organization, which are not deducted from amounts due a subordinate manager, shall be deducted from amounts due the MANAGER.

* * * * *

4. ALLOWANCE FOR SUPPLIES, ADVERTISING AND EXHIBITS:

A supply account shall be established for the MANAGER and charged with the cost of all supplies furnished, advertising costs paid and exhibit expense paid by the COMPANY on behalf of the MANAGER as follows:

[There followed an explanation of the meaning of "supplies," etc.]

* * * * *

THE COST of all other items, not specified above, shall be paid by the MANAGER and shall not be charged against the supply account of the MANAGER.

> As of the close of the contract year, the supply account of the MANAGER shall be credited with * * * [at this point was set forth a specified amount per set: $1.00 for a World Book, district manager] on total net accepted orders taken in the territory assigned to the MANAGER during the contract year. The total amount of such credit shall not exceed the total amount charged as specified above. In the event that the charges exceed the credits, the net charge remaining shall be recovered by the COMPANY from quality bonus payments or other amounts due the MANAGER.

(c) The foregoing excerpts were taken from the branch office division manager's agreement form for the sales of World Books. In all essentials (with the exception noted hereinafter), the contracts of all managers for both World Book and Childcraft were identical. However, it should be kept in mind that plaintiff employed "managers" who held different titles and were at varying levels. The charges made against a manager for orders which failed to become bona fide varied from level to level. A district manager was charged with commissions paid to him and to his subordinates. A regional manager was charged with commissions paid to him and to all of his subordinates. A senior division manager was charged with commissions and office allowances paid to him and commissions paid to all of his subordinates, except district managers and their subordinates.

18. The system of compensation under the new contracts is illustrated by the following table showing commissions for a sale of a World Book set (red binding) made by the lowest level of sales representative under the supervision of an area manager, district manager, and senior division manager:

Sales level	*Compensation*
Representative's commission	$22.00
Area Manager's commission	6.00
District Manager:	
Basic commission	5.00
Quality bonus	3.00
Senior Division Manager:	
Basic commission	9.00
Quality bonus	4.00
Total	49.00

19. Under the old contracts the requirement that an order be bona fide prior to the crediting of commissions had been considered necessary by the plaintiff in order to avoid the possibility that a commission of $24, or more, would be credited and paid when the purchaser of the encyclopedia had paid a lesser amount as a down payment and thereafter made no further payments. Plaintiff's experience over the years prior to October 1, 1954, indicated that only about 10 percent of all accepted orders failed to become bona fide. Under the new contracts, in order to compensate for the average loss on orders which failed to become bona fide, commissions, although payable on acceptance of the order, were reduced by approximately 10 percent, and the compensation of managers was increased accordingly.

20. Although commissions were reduced under the new contracts, the total compensation of plaintiff's sales force for each accepted order which became bona fide remained the same. The decrease in the amount of commission was offset by the introduction of quality bonuses for managers. Thus, the plaintiff's total compensation of its sales force per bona fide order of the World Book (red binding) under both the old and the new contracts was $49.

21. Although the amounts and time periods differed, both the old and the new contracts contained essentially the same type of condition that had to be met with respect to payments by purchasers before orders became bona fide.

22. (a) Plaintiff treated an accepted order under the new contracts as bona fide if the purchaser paid the amount specified in the particular contract before the expiration of 6 months following the end of the month in which the order was accepted, which amount was equal to the down payment plus 2 monthly installments.

(b) While, under the standards established by plaintiff, it might take as long as 6 months following the end of the month in which a particular order was accepted to determine whether the order became bona fide, an order could become bona fide in less than a period of 6 months. Orders accompanied by a full cash payment became bona fide upon the date of acceptance. An installment order became bona fide upon payment by the purchaser of the first 2 monthly installments when due (*i.e.*, within 3½ months

following acceptance of the order), or at any subsequent time within (but not later than) 6 months following such acceptance.

23. Whether an order became bona fide depended solely upon the standards for "bonafication" being met, and not upon the fact that all payments ultimately were collected. *E.g.*, if a purchaser paid the exact amount specified in the contract at any time within the period required to make the order bona fide, but thereafter refused to make any further payments, the order remained bona fide. However, if a purchaser paid an amount less than that specified in the contract within the time required but thereafter paid in full for the publication, the order did not become bona fide.

24. The standards that plaintiff adopted and required to be met before an order became bona fide were based upon its collection experience. Plaintiff considered that a customer who paid on time the 2 monthly installments required to make a sales order bona fide was likely to be a good credit risk, and that one who failed to pay 2 monthly installments within the specified 6-month period was likely to be a poor credit risk.

25. (a) The changed system of compensation under the new contracts was the result of a study motivated primarily by plaintiff's sales force.

(b) Plaintiff contends that it changed its system of compensation solely for the following reasons: (1) the old system was complex and confusing to salesmen, whereas the new system was more acceptable to the salesmen; (2) the old commission system had been too complex to permit the introduction of mechanized accounting, whereas the new system permitted plaintiff to mechanize accounting for commissions; and (3) the new system was designed to secure better quality business by rewarding managers with quality bonuses for good business and penalizing them with charges for commissions and quality bonuses on poor business; thus, managers having the responsibility for the quality of credit sales had an incentive to employ good salesmen and to give them proper training and supervision. The evidence supports plaintiff's contentions. However, the foregoing reasons were not the only ones which prompted plaintiff to change its system of compensation of its sales force.

(c) Considering all the facts of record, it appears reasonable to conclude that another reason which prompted plaintiff to change its system of compensation was the fact that by doing so tax savings would result from the accelerated deductibility of the commissions payable to plaintiff's sales force.

26. To facilitate the administrative task of computing and paying quality bonuses, plaintiff divided its managers into three groups, each with a different set of quality bonus periods, which consisted of 3 months. The quality bonus quarters of Group A ended on January 31, April 30, July 31, and October 31; those of Group B ended on February 28 (or 29), May 31, August 31, and November 30; and those of Group C ended on March 31, June 30, September 30, and December 31.

27. (a) Plaintiff maintained the following 3-part set of payroll records for each of its managers for the purpose of computing the quality bonuses payable to them:

(1) A "Monthly Statement of Potential Quality Bonus Credits," prepared at the end of each month, showing net orders [1] accepted during the month from each manager's territory. This statement showed for each such order the amount of potential quality bonus to which the manager would be entitled should the order become bona fide.

(2) A "Monthly Statement of Quality Bonus Charges," which was based upon examination of net orders accepted in each calendar month and prepared after expiration of the succeeding 6-month period, to determine whether the orders had become bona fide, and which showed the number of orders that failed to become bona fide. For each such order which failed to become bona fide, this statement showed, *inter alia*, the amount of commissions and quality bonus to be charged to the manager.

(3) "Quarterly Statements," in the form of ledger cards, covering each consecutive quarterly bonus period, on which the total monthly credits and total monthly charges shown on the above-described monthly statements for the quarter were entered in order to obtain the amount payable to the manager for the quarterly period.

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[1] The term "net orders accepted" was explained as being "orders accepted less orders countermanded, plus orders reinstated."

(b) The effect of the credits and charges entered on the payroll records described above is illustrated in terms of a typical sale of a World Book in the red binding by the following: At the end of the month of acceptance of the order, plaintiff would have credited the district manager with his potential quality bonus of $3, and the senior division manager with his potential quality bonus of $4. At the end of the sixth succeeding month, if the sale had failed to become bona fide, plaintiff would have charged the district manager with $36 (representing the $3 quality bonus to which he was not entitled and the $33 of commissions paid to him and his subordinates on the order); and plaintiff would have charged the senior division manager with $13 (representing his commission and quality bonus). It is apparent from the foregoing that the charges to a manager's quality bonus account, if an order failed to become bona fide, exceeded the amount of quality bonus which would have been credited to his account if the order had become bona fide.

28. Between 7 and 8 months following the ending of each manager's quality bonus quarter, plaintiff paid to him the amount shown on his quarterly statement. If the charges against the manager shown on his quarterly statement exceeded his credits, no quality bonus payment was made to him. While he was not required to repay any deficit, plaintiff would offset the deficit against quality bonuses credited to the manager during subsequent quarters. If a subordinate manager had a deficit for any quarter, plaintiff charged that deficit against the credits to his superior for the quarter, and, if the deficit exceeded the amount of such credits, plaintiff would offset such excess against credits to the superior for future quarters. If plaintiff subsequently recovered such deficit from the subordinate manager for a future period, plaintiff then credited to the account of the superior the amount previously offset against his credits.

29. (a) Prior to and during the 2 taxable years ended September 30, 1955, and September 30, 1956, plaintiff, as of the date of acceptance of each order, accrued on its journal, and at the end of the month accrued in a ledger account, the full selling price of all sets of World Book and Childcraft for which it had accepted orders that month.

In the case of sales returns, the accruals of commissions and quality bonuses were reversed. If a countermanded order was reinstated, the commission and quality bonus were again accrued.

(b) On its books for any given year, plaintiff accrued the full selling price of all sets of World Book and Childcraft for which it had accepted orders during that year, including sales made on the installment plan. Plaintiff also included as income on its federal income tax returns the total amount of all sales accrued on its books during the particular year.

30. Plaintiff used the reserve method of accounting for bad debts on its books of account for the taxable years ending September 30, 1955, and September 30, 1956, and for each prior taxable year. Plaintiff, both on its books and its federal income tax returns for such years, reduced the total amount of accrued sales by an addition to a reserve for bad debts. The addition was based upon plaintiff's actual bad debt experience for the preceding 10 years. Plaintiff followed the same bad debt reserve method on its income tax returns for all such years.

31. Plaintiff did not establish a separate fund from which to pay the quality bonuses it would be obligated to pay on accepted orders that actually became bona fide. Plaintiff was under the accrual method of accounting, and, therefore, it was not required to establish a segregated fund in order to be entitled to deduct an accrued liability.

32. (a) On its books of account for the taxable years ended September 30, 1955, and September 30, 1956, and for each prior taxable year, plaintiff accrued the full amount of commissions (under both the old and the new contracts) on the net orders for World Book or Childcraft accepted by it during such taxable year. Plaintiff similarly accrued deductions for commissions under the new contracts on its income tax returns for the taxable years ended September 30, 1955, and September 30, 1956; however, for these years as well as for prior years, plaintiff deducted commissions under the old contracts in the year in which the sale to which the commission related became bona fide.

(b) There is a dispute between the parties as to whether the revision of plaintiff's treatment of compensation constituted a "change of accounting method." Regardless of the question of accounting semantics raised by the use of the word "change," a *change* occurred with respect to the payment of commissions, and a *change* occurred in the status accorded the commission figures entered in plaintiff's journal on the date of the acceptance of an order and the commission figures entered on its ledger at the end of each month. Under the old contracts, the commissions on accepted orders were entered on plaintiff's journal and ledger as credits to its accrued commissions account. This account represented "expected" liabilities that might or might not become legally enforceable obligations. Under the new contracts, commissions on an accepted order were entered as legally enforceable obligations to the sale representatives on the date of "sale." While it is also true that plaintiff's balance sheet, attached as Schedule L to its federal income tax return for the taxable year ended September 30, 1956, showed a larger amount of accrued commission on September 30, 1956, than on September 30, 1955, this does not disprove plaintiff's own statement (quoted in finding 16, *supra*) that "there were no credits to the former accrued commission account, as in prior years, since current commissions became a liability at the date of sale."

(c) For fiscal 1955, plaintiff was able to deduct not only all of the accrued commissions (on orders accepted in prior years), which commissions, under the old contracts, became payable in that year, but also the full commissions on all orders accepted during that year, which commissions were payable, under the new contracts, upon acceptance.

33. The amount of quality bonus accrued on plaintiff's books and included in the deductions for "salaries and wages" in the taxable years ended September 30, 1955, and September 30, 1956, was determined by plaintiff as follows:

(a) First, plaintiff, as of the last day of the taxable year, determined the total amount of potential quality bonus which had been credited each month to the potential quality bonus accounts of all its managers.

(b) The exact amount of the plaintiff's quality bonus liability to its managers for all months which ended at least

6 months prior to the end of the taxable year (hereinafter "closed months") could be ascertained because all orders taken in such closed months either were or were not bona fide as of the end of the taxable year. Plaintiff subtracted the total amount of charges to its managers' quality bonus accounts for the closed months from the total of all potential quality bonus for orders accepted during the year referred to in (a).

(c) For months which ended less than 6 months prior to the end of the taxable year (hereinafter "open months"), the exact amount of plaintiff's liability to its managers for quality bonuses could not be ascertained because it would depend in part on future happenings, *i.e.*, whether or not an order for which the "bonafication" period was open became bona fide. Therefore, plaintiff made an estimate of what it expected the charges to its managers' quality bonus accounts would be on orders which would in the future fail to become bona fide and called such estimate "provision for future charges." It subtracted this provision for future charges from the total potential quality bonus credit remaining after the subtraction of the known charges for the closed months described in (b) above and claimed the resulting total as a deduction for federal income tax purposes.

(d) Plaintiff computed the aforesaid provision for future charges at the end of the fiscal year 1955 by consistently using its experience over a basic period comprised of the first 6 months of that year. Plaintiff computed the ratio for the 6 closed months of (1) the total charges to managers' accounts to (2) the total potential quality bonuses credited to managers' accounts. The resulting figure represented the percentage of potential quality bonus which had not become payable because of actual charges to managers' accounts resulting from orders failing to become bona fide. Plaintiff assumed that the same percentage of chargebacks to total quality bonus would apply in the open months as had applied in the 6 preceding closed months. Then plaintiff multiplied the total potential quality bonus credits for orders accepted in the last 6 months of fiscal 1955 by the percentage derived from its experience in the first 6 months. The resulting amount was plaintiff's "provision for future charges."

(e) Commencing with the month of October 1955, plaintiff computed a new percentage figure each month, changing the former base period by adding the experience of the most recent closed month and deleting the experience of the oldest month used in the prior base period. Thus, the base period used thereafter was always the most recent 6-month period for which the "bonafication" period had expired. The following chart, prepared by plaintiff, sets forth the actual figures used by plaintiff in estimating the provision for future charges as of the end of its taxable years 1955–59 and shows that the percentage figure could and did vary during the indicated consecutive periods:

Percentages of (1) chargebacks of commissions, basic commissions, and quality bonuses to (2) total potential quality bonuses, used in computing estimates of expected chargebacks.

Date as of which computed: Sept. 30—	Percentage	Base period		
		Months of acceptance of orders	Months in which bona fide period expired	Open period of sales to which percentage was applied
1955	19.23	Oct. 1954–Feb. 1955	Apr.–Aug. 1955	Mar.–Sept. 55
1956	25.51	Sept. 1955–Mar. 1956	Mar.–Sept. 1956	Apr.–Sept. 56
1957	25.67	Sept. 1956–Feb. 1957	Mar.–Aug. 1957	Mar.–Sept. 57
1958	31.31	Mar. 1957–Feb. 1958	Sept. 1957–Aug. 1958	Mar.–Sept. 57
1959	28.16	Dec. 1957–Nov. 1958	June 1958–May 1959	Mar.–Sept. 58

34. Approximately 96½ percent of the sales for World Book and 94½ percent of the sales for Childcraft made during the fiscal years ended September 30, 1955, and September 30, 1956, became bona fide. While there is some evidence indicating that within any one year there was little change from month to month in the percentage of sales orders that became bona fide, it also is true that the cumulative effect of even a small decline in the percentage of orders that became bona fide during a particular year could result in a substantial change for that year. Even a relatively slight decline in the percentage of orders becoming bona fide would have caused a substantially magnified decline in plaintiff's liability for quality bonus payments. For example, see finding 27 (b), *supra*.

35. Various factors not under the control of the plaintiff could affect the relative number of orders which would become bona fide. A sudden drop in collections would have reduced the amount payable to plaintiff's managers, with respect to quality bonuses, below the amount shown by plaintiff as accrued on its books of account and on its federal income tax returns.

36. At the end of each month, when plaintiff ascertained the actual charges to managers' quality bonus accounts for commissions and quality bonuses which had been credited on sales for the sixth preceding month but which had failed to become bona fide, plaintiff substituted such actual charges for the charges which had been estimated in the "provision for future charges" and adjusted its books of account accordingly. Similarly, after ascertaining, following the close of each taxable year, the actual charges for commissions and quality bonuses on sales for the last 6 months of such taxable year that had failed to become bona fide, plaintiff reflected in its income tax return for the succeeding year the difference between such actual charges and the provision for future charges previously calculated.

37. (a) The aggregate amounts of all quality bonuses, including potential quality bonuses, credited to managers on sales of World Book and Childcraft for the fiscal years ended September 30, 1955, and September 30, 1956, were $1,310,194 and $1,633,693.10, respectively. Plaintiff reduced the aggregate amount of quality bonus for each of those fiscal years (1) by the commissions and quality bonuses on sales which had failed to become bona fide and for which the "bonafication" period had expired and (2) by the provision for future charges with respect to net orders accepted during the second 6-month period in each of those years. Then plaintiff, at the end of the taxable years 1955 and 1956, accrued on its books and claimed as a deduction for quality bonuses the total sums of $998,023.43 and $1,138,499.25, respectively.

(b) At the end of each of the fiscal years, only a relatively small part of the accrued quality bonuses had actually been paid. The amount that remained unpaid at the end of each of the respective years was carried on plaintiff's books under the caption "Accrued Commissions of Educational Division," which included certain standard commissions and

production bonuses. As of September 30, 1955, the amount of quality bonuses which had been accrued, but had not been paid, was $765,294.30; thus, as of that date, quality bonus payments totaling $232,729.13 ($998,023.43 less $765, 294.30) had been paid by plaintiff.

(c) With respect to the taxable year ended September 30, 1955, for which the plaintiff accrued $765,294.30 as its quality bonus liability for orders accepted during that year, the actual amount of quality bonus subsequently paid was $696,-727.37. With respect to the taxable year ended September 30, 1956, for which the plaintiff accrued $895,212.86 as its quality bonus liability for orders accepted during that year, the actual amount of quality bonus subsequently paid was $849,517.38. The difference between the amount charged as an accrued liability and the amount which was actually paid to the managers during each of the years 1955 and 1956 was credited to quality bonus expense in the following year.

38. Plaintiff did not refile its income tax returns for the taxable years ended September 30, 1955, and September 30, 1956, to show an adjustment for the difference between the amount accrued as a liability for quality bonuses and the amount actually paid to its managers. Plaintiff contends that accrual-basis taxpayers are required to base their income tax returns on accruals to the end of the taxable year, and that adjustments to accrued items occurring after the end of the taxable year are required to be reflected in the latest taxable periods in which they occur.

39. On plaintiff's federal income tax returns for the taxable years in issue, deductions for both commissions and quality bonuses were included under the general category "Salaries and Wages (not deducted elsewhere)." Such deductions, as to the Educational Division, for the fiscal year ended September 30, 1955, included both deductions for commissions under the old contracts and deductions for commissions and quality bonuses under the new contracts. The deductions for fiscal 1955 totaled $14,867,640.77, of which sum the amount of $998,023.43 was for quality bonuses. Such deductions for the fiscal year ended September 30, 1956, totaled $14,738,614, of which sum the amount of $1,138,499.25 was for quality bonuses. Said income tax returns did not specifically refer to, or reflect the amount of, quality bonuses.

While the returns (Form 1120) and instructions relating thereto asked for supporting schedules for various items, such schedules were not specifically requested with respect to deductions listed opposite Item 17, mentioned above.

40. As noted above, plaintiff's deduction in Item 17 (Salaries and Wages * * *) on its federal income tax return for the taxable year ended September 30, 1955, included both deductions for commissions under the old contracts taken in the year in which the sale became bona fide and commissions and quality bonuses under the new contracts accrued in the year of acceptance of the order. Thus, on its income tax return for the taxable year ended September 30, 1955, plaintiff, for its Educational Division, showed a deduction of $2,751,187.74 as an adjustment to Schedule M for charges to accrued commissions in excess of provision. Said sum of $2,751,187.74 represents commissions under the old contracts which had not been deducted for the preceding tax year and which were deducted in plaintiff's income tax return for the taxable year ended September 30, 1955, in accordance with plaintiff's normal practice, which amount would have been deducted even if there had been no change in its contracts with its salesmen.

41. In March 1957, Internal Revenue Agent Thomas B. Harlor audited plaintiff's federal income tax return for the taxable year ended September 30, 1955, and plaintiff made available to him all of its general books of accounts and records that he requested during the course of his examination. Agent Harlor had not previously audited plaintiff's income tax return and was not familiar with plaintiff's books and records.

42. Revenue Agent Harlor did not check each item on plaintiff's income tax return for the taxable year ended September 30, 1955, because in his judgment it was not feasible to do so, due to the voluminous records maintained by plaintiff. Instead of making a complete examination, Agent Harlor selected certain items, either because of the large amount or the unusual nature thereof, which he considered required further examination or analysis. Agent Harlor usually requested plaintiff to furnish detailed analysis, vouchers, and canceled checks with respect to such items.

43. (a) In connection with his audit and examination of plaintiff's federal income tax return for the taxable year ended September 30, 1955, Agent Harlor investigated plaintiff's deduction under Item 17 for salaries and wages of the Educational Division, amounting to a total of $14,867,640.77, including the "Schedule M" adjustment for charges to accrued commissions in excess of provision amounting to $2,751,187.74.

(b) Agent Harlor (as noted in finding 16(b), *supra*) requested and received from plaintiff a written explanation of the above-mentioned "Schedule M" adjusted figure of $2,751,187.74. While such adjustment figure represents "charges to accrued commissions in excess of provision" and essentially relates to commissions under the old contracts in effect prior to October 1, 1954, which did not include any "quality bonus," the above-mentioned explanation clearly refers not only to plaintiff's old contracts and its former method of accounting for commissions thereunder on its tax returns, but also to the new contracts. It is significant to note that the explanation does not mention the "quality bonus."

(c) During the course of Agent Harlor's investigation and audit, he prepared certain work papers. Regarding the sources of the information reflected in his work papers, Agent Harlor testified that such information was usually obtained from "the general books of accounts and taxpayer's work papers analysis"; that his work papers with respect to "Salaries and Wages" could have been based upon both the books of account of plaintiff and work papers submitted to him by plaintiff, but that "from the appearance of the work paper, it was probably from the work papers of the taxpayer." Agent Harlor testified that his work papers reflect that the item for salaries and wages was broken down into various categories, the largest of which was for "Selling and Promotional," amounting to $10,519,761.24. Agent Harlor compared this amount with the amount of total sales, and the resulting ratio was compared and found consistent with the ratios for earlier years. The breakdown of the items comprising plaintiff's deduction for salaries and wages of the Educational Division, as

reflected by Agent Harlor's work papers, did not include any reference to "quality bonus," and he had no recollection at the time of the trial that any of the figures in his work sheets included "quality bonuses."

44. Plaintiff also furnished to Revenue Agent Harlor one of the new contracts; but it was the standard contract used for agreements between plaintiff and its field representatives (house-to-house salesmen), and it contained no mention of the "quality bonus."

45. As a result of his audit of plaintiff's federal income tax return for the year ended September 30, 1955, Revenue Agent Harlor proposed certain adjustments resulting in an income tax deficiency of $12,842.10. The parties are in dispute with respect to the credibility of Agent Harlor's testimony that he had no recollection of the existence of a classification of commission expense identified as the "quality bonus," and that he never approved of plaintiff's accounting treatment of any such items. It is important to note that a copy of Agent Harlor's audit report, submitted to his superiors under date of April 17, 1957, contains no mention of the quality bonus. Plaintiff's books of account contained entries with respect to quality bonuses and such books of account were available to Agent Harlor for examination. However, there is no evidence that Agent Harlor actually examined the books of account and noted entries relating to quality bonuses, and it may be reasonably inferred from the entire record that he did not do so. In view of the facts set forth above, it would appear reasonable to conclude that Agent Harlor simply did not examine books of account which identified certain entries as being related to quality bonuses, and that he relied solely upon work papers, documents, and the explanation of the "Schedule M" adjustment furnished to him by plaintiff.

46. Plaintiff agreed to the adjustments proposed by Revenue Agent Harlor. In September 1957, the Commissioner of Internal Revenue assessed a deficiency for the taxable year ended September 30, 1955, of $12,842.10 in tax and $1,097.91 in interest, or a total of $13,940.01. Plaintiff paid said deficiency on September 30, 1957.

47. On August 1, 1958, Internal Revenue Agent Selma J. Mortenson commenced an examination of plaintiff's income tax return and books of account for the taxable year ended September 30, 1956, including an examination of the books of account and records of plaintiff's Educational Division, which published World Book and Childcraft.

48. (a) Revenue Agent Mortenson did not personally testify during the trial; but the parties stipulated that, in the event she were called as a witness, she would testify to facts contained in a certain portion of a letter sent by her to defendant's attorney. On the basis of the entire record, it is concluded that the following findings are reasonably accurate.

(b) During the course of her examination of the books and records of plaintiff's Educational Division, Agent Mortenson was in constant contact with Mr. Joseph C. Hurtgen, assistant treasurer and tax manager of Field Enterprises, Inc. They discussed plaintiff's operations, accounting method, contracts, the quality bonus, and certain books of account relating to the taxable years ending September 30, 1955, and September 30, 1956.

(c) While the record does not definitely disclose just what contracts Agent Mortenson asked plaintiff's representatives to furnish, or that she asked for and actually received a full set of contracts, it is clear that she requested and received certain new contracts, and probably a full set. Agent Mortenson asked many questions about how the quality bonus accounts worked, and Mr. Hurtgen cooperated with her. She also raised questions with respect to the proper time of accrual of quality bonuses, and Mr. Hurtgen explained the method used by plaintiff. Mr. Hurtgen did not object to her questioning with respect to this issue. At Agent Mortenson's request, plaintiff's journal sheets and ledgers for the taxable year ended September 30, 1955, as well as for the taxable year ended September 30, 1956, were furnished to her. However, Agent Mortenson did not specifically advise any of plaintiff's representatives that she was reexamining plaintiff's taxable year ended September 30, 1955, as well as making a general examination of the taxable year ended September 30, 1956. As best it can be determined from the record, plaintiff made available to Agent Mortenson

its records for the taxable year ended September 30, 1955, as well as for the taxable year ended September 30, 1956, for the purpose of enabling her to understand the fiscal 1956 opening balances and the working of the commission and quality bonus accounts. On the basis of books and records and the information furnished to Agent Mortenson, she was able to make and did make adjustments for both fiscal 1955 and 1956. Although Agent Mortenson might have made the adjustment for quality bonus deductions which she proposed in the year 1956 without making a compensating adjustment for the year 1955, the adjustment would have been smaller. Agent Mortenson could not have accurately adjusted quality bonus deductions for the year 1956 without checking the balances for that year against plaintiff's books of account relating to its managers and sales representatives for fiscal 1955; and such a check necessarily resulted in some examination of plaintiff's books of account for fiscal 1955.

(d) The issue with respect to the proper time of accrual of quality bonus deductions for federal income tax purposes was the same in both fiscal 1955 and 1956.

(e) About October 1, 1958, Agent Mortenson presented Mr. Hurtgen with a worksheet which reflected that Agent Mortenson was considering making a proposed adjustment for the taxable year ended September 30, 1955, and she requested certain additional information. At that time Mr. Hurtgen began to think that Agent Mortenson was making an examination of fiscal 1955, whereupon he refused to give her further information, or to make plaintiff's books of account for the fiscal year 1955 available to her. She terminated her examination at the offices of the plaintiff.

(f) In all probability, Mr. Hurtgen and possibly other representatives of the plaintiff knew that the application of Agent Mortenson's method of accounting, with respect to the item of the quality bonus to both the fiscal years 1955 and 1956, would result in a change in each of those years. But Mr. Hurtgen presented credible testimony to the effect that he believed no change for fiscal 1955 actually could or would be made unless a re-examination of that year was made by the Internal Revenue Service after due notice to plaintiff; that he was unaware of the fact that Agent Mortenson was re-

examining fiscal 1955 until after she was furnished with information that prompted and enabled her to make proposed adjustments for both fiscal 1955 and 1956; and that his suspicions were first aroused that Agent Mortenson was re-examining fiscal 1955 about October 1, 1958.

(g) Plaintiff did not request a second inspection of its books of account for the fiscal year ended September 30, 1955; and no notice was ever given in writing to plaintiff by the Internal Revenue Service that another inspection would be made of plaintiff's books of account for the taxable year ended September 30, 1955.

(h) Although it is obvious that Agent Mortenson made some examination of plaintiff's books and records for the taxable year ended September 30, 1955, the record does not clearly disclose the extent of such examination; but it appears to have been of a limited nature rather than a complete re-examination.

49. On October 23, 1958, a conference was held between representatives of plaintiff and Agent Mortenson. At that meeting Agent Mortenson first proposed a specific adjustment for the fiscal year ended September 30, 1956; but she did not propose a specific adjustment for the fiscal year ended September 30, 1955.

50. (a) On October 28, 1958, certain of plaintiff's representatives and Agent Mortenson held another meeting. As best it can be determined from the testimony, Agent Mortenson did not specifically propose, at that meeting, an adjustment for the fiscal year 1955; but she did ask plaintiff to execute a consent for an extension of the period of limitations on the assessment of deficiencies for the taxable year ended September 30, 1955, which would otherwise expire on December 15, 1958. It then became apparent that Agent Mortenson had in mind making a proposed adjustment for fiscal year 1955. Plaintiff's representatives refused to execute the consent to an extension of the period of limitations on assessment, and they challenged Agent Mortenson's right to make a re-examination of plaintiff's books of account for the taxable year ended September 30, 1955.

(b) While it appears that in all probability Agent Mortenson continued her work with respect to plaintiff's in-

come tax returns for the fiscal years 1955 and 1956, it is reasonably clear that about October 1, 1958, she terminated her examination of the books of account for the year 1955. There is no evidence that Agent Mortenson made any examination of plaintiff's books of account for either the fiscal year 1955 or 1956 subsequent to the meeting on October 28, 1958. Obviously, the adjustments and the tax deficiency for fiscal 1955 proposed by Agent Mortenson were based upon the examinations she made of plaintiff's books of account for both the fiscal years 1955 and 1956.

(c) It does not appear that either prior to or at the meeting on October 28, 1958, Agent Mortenson specifically advised any of plaintiff's representatives that she had actually examined plaintiff's books of account for the fiscal year 1955 for the purpose of proposing adjustments for that year. However, it is clear that several weeks before that meeting the suspicions of certain of plaintiff's representatives had been alerted to the possibility that Agent Mortenson might be considering a proposed adjustment for the fiscal year 1955. At the time of the meeting, Agent Mortenson clearly indicated that she had made such inspection as was necessary for her to propose a deficiency tax assessment against plaintiff.

51. (a) Revenue Agent Mortenson prepared a supplemental report, dated November 19, 1958, proposing a deficiency in income tax for the taxable year ended September 30, 1955. Such supplemental report was transmitted to plaintiff by letter of the Internal Revenue Service dated January 12, 1959. The aforementioned letter of January 12, 1959, clearly refers to the supplemental report of Agent Mortenson, dated November 19, 1958, as relating to the "Fiscal Year Ended: 9–30–55," and the letter reads in pertinent part:

> Enclosed you will find copy of report covering *examination* recently made by a representative of this office * * * (Emphasis supplied.)

The supplemental report of Agent Mortenson, dated November 19, 1958, contains the following statement:

> The return filed for this year [1955] was *previously examined* and a report submitted April 17, 1957. This is a supplemental report. (Emphasis supplied.)

(b) On December 11, 1958, plaintiff received an official written notice, pursuant to section 7605 of the Internal Revenue Code of 1954, from the Acting Regional Commissioner that a re-examination of its books of account and records for the taxable year ended September 30, 1955, would be made. On the following day, December 12, 1958, the Commissioner of Internal Revenue sent plaintiff a statutory notice of deficiency. The statutory period for the assessment of deficiencies for plaintiff's fiscal year ended September 30, 1955, was to have expired on December 15, 1958. Attached to such deficiency notice was a statement entitled "Tax Liability for the Taxable Year Ended September 30, 1955," which contained the following: "In making the determination of your income tax liability, careful consideration has been given to the Supplemental Report dated November 19, 1958, submitted by Agent Mortenson." The adjustments to taxable income reflected in the statement precisely match those in Agent Mortenson's report.

52. (a) It is clear that, as a result of the adjustments proposed by Agent Mortenson in her report of November 19, 1958 (based on the examination relating to the taxable year ended September 30, 1955), the Commissioner of Internal Revenue, for such fiscal year, disallowed $647,657.14 of the $998,023.43 deduction for quality bonuses claimed by plaintiff, thereby reducing such deduction to a total of $350,366.29.

(b) The $647,657.14 disallowed by the Commissioner represented the portion of the deduction claimed for quality bonuses which was attributable to orders for quality bonus quarters ending within the second 6 months of the taxable year, *i.e.*, orders accepted after the following dates:

(i) For managers in Group A, February 1, 1955, the first day of the quality bonus quarter ending on April 30, 1955;

(ii) For managers in Group B, March 1, 1955, the first day of the quality bonus quarter ending on May 31, 1955; and

(iii) For managers in Group C, April 1, 1955, the first day of the quality bonus quarter ending on June 30, 1955.

53. (a) Following the general examination made by Agent Mortenson of plaintiff's income tax return and books of

account and records for the taxable year ended September 30, 1956, and such examination as she made with respect to the taxable year ended September 30, 1955, Agent Mortenson submitted a report, dated January 16, 1959, in which, among other adjustments, she proposed that $116,542.73 of the $1,138,499.25 deduction claimed by plaintiff for quality bonuses in fiscal 1956 be disallowed. Thereafter, for the taxable year ended September 30, 1956, the Commissioner of Internal Revenue disallowed $116,542.73 of the above-mentioned deduction, thereby reducing such deduction to $1,021,956.52.

(b) The $116,542.73 disallowed by the Commissioner represented the excess of the amount of $764,199.87, described below, over the $647,657.14 disallowance for the preceding taxable year. The said amount of $764,199.87 represented the portion of the deduction claimed for quality bonus quarters ending within the second 6 months of the 1956 taxable year.

54. For the taxable years ending September 30, 1955, and September 30, 1956, plaintiff accrued quality bonuses on its sales in the amounts of $998,023.43 and $1,138,499.25, respectively, totaling $2,136,522.68. The Commissioner of Internal Revenue allowed *net* quality bonuses actually paid on sales orders by plaintiff in each of the above-mentioned years which had become bona fide by September 30, 1955, and September 30, 1956. The Commissioner allowed quality bonuses in the amount of $350,366.29 for the year 1955, and in the amount of $1,021,956.52 for the year 1956, making a total of allowed quality bonuses of $1,372,322.81 for such 2-year period. The Commissioner disallowed quality bonuses in the amount of $647,657.14 for the fiscal year ended September 30, 1955, and in the amount of $116,542.73 for the fiscal year ended September 30, 1956, making a total quality bonus disallowance of $764,199.87 with respect to such 2-year period.

Plaintiff prepared a schedule, based on an analysis of approximately 11 percent of plaintiff's orders for fiscal 1956. According to the schedule, the number of orders which had not become bona fide as of September 30, 1956, but regarding which the "bonafication" period was still open, amounted to 29.2 percent. Plaintiff (1) applied the 29.2 percentage

figure to the quality bonuses on all orders for fiscal 1956 and (2) deducted the quality bonuses on orders which had failed to become bona fide by September 30, 1956. In this way, plaintiff concluded that the quality bonuses for fiscal 1955 and fiscal 1956, which had become bona fide by September 30, 1956, would total $1,901,817.61. Plaintiff contends that this schedule reflects that the quality bonuses, for such period, allowed by the Commissioner (in the amount of $1,372,-322.81) fell short by $529,494.80, when compared to plaintiff's computation (of $1,901,817.61). Therefore, according to plaintiff, $529,494.80 (or approximately 70 percent of the $764,199.87 of quality bonuses disallowed by the Commissioner) related to sales orders which had already become bona fide by the end of the 2-year period.

It should be recognized that, under the new contracts, quality bonuses were subject to certain offsets such as commissions and bonuses paid on sales orders which did not become bona fide. Therefore, the quality bonus in the above-mentioned amount of $1,901,817.61 calculated by plaintiff does not reflect such offsets and such amount is overstated to that extent.

55. The Commissioner of Internal Revenue, on audit of plaintiff's income tax returns both for the taxable years in issue and for prior taxable years, did not make any adjustment in plaintiff's deductions for commissions under the old contracts.

56. (a) Carman G. Blough, a well-known certified public accountant, testified as an expert on behalf of plaintiff. The following findings are based on Mr. Blough's uncontradicted testimony.

(b) It is a basic principle of accrual accounting that costs be matched to the revenue which they produce so that both are reported in the same year.

(c) If a corporation sells merchandise through installment sales, compensates its salesmen on a commission basis, and accrues for each year the income from all sales during that year, it also should, under proper accounting principles, accrue all commissions payable on such sales. The commissions should be so accrued even though the agreement such corporation has with its salesmen provides that specified

commissions shall not be paid unless the purchaser pays for the merchandise. Such commissions are an absolute liability and not a contingency.

(d) If a corporation makes sales under such a sales commission plan and uses the reserve method of accounting for bad debts, sound accounting principles also require that the corporation reduce its accrual of commissions by the portion thereof that its experience indicates will not have to be paid. This reduction in the commissions is the equivalent of a reserve, except that it relates to a cost rather than to a revenue. By this method, sales and commissions are accounted for on the same type of accrual basis.

(e) Based on generally accepted principles of accounting, plaintiff's system of accounting for commissions under the old contracts on its income tax returns, prior to the fiscal year 1955, was incorrect.

(f) The method used by plaintiff in accruing commissions and quality bonuses with respect to sales of World Book and Childcraft under the new contracts for the fiscal years ended September 30, 1955, and September 30, 1956, was correct, and the only appropriate one, under accepted principles of accounting.

57. As a result of the disallowances described in findings 52, 53, and 54, *supra*, the Commissioner of Internal Revenue assessed the following deficiencies:

Taxable year ended—	Income tax	Interest	Total
Sept. 30, 1955	$336,781.72	$69,736.88	$406,518.60
Sept. 30, 1956	60,602.22	8,916.83	69,519.05
			476,037.65

Plaintiff paid $465,626.06 of said deficiencies on May 28, 1959, and the balance of $10,411.59 on June 11, 1959.

58. On June 24, 1959, plaintiff filed with the District Director of Internal Revenue claims for refund of the $476,037.65 of deficiency income tax and interest assessed against, and paid by, plaintiff. On or about November 9, 1959, the Commissioner of Internal Revenue disallowed such claims for refund and notified plaintiff accordingly. No

part of said sum of $476,037.65 has been repaid or credited to plaintiff.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover, and the petition is dismissed.

APPENDIX B

Statutes and Regulations Involved

Statutes

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) PERMISSIBLE METHODS.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

* * *

(2) an accrual method; . . .

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

SEC. 7605. TIME AND PLACE OF EXAMINATION.

* * *

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(b) RESTRICTIONS ON EXAMINATION OF TAXPAYER. —No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Regulations

§ 1.446-1. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

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(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

* * *

(b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

* * *

(c) *Permissible methods*—(1) *In general.* Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * *

(ii) *Accrual method.* Generally under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise, the extent to which indirect costs shall be included in computing cost of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books.

* * *

§ 1.461-1. General rule for taxable year of deduction.

(a) General rule—

* * *

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However,

any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

§ 301.7605-1. Time and place of examination.

* * *

(b) *Restrictions on examination of taxpayer.* No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless an authorized internal revenue officer, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

APPENDIX C

Opinion of the United States Court of Appeals for the Sixth Circuit in *Ohmer Register Co.* v. *Commissioner*

OHMER REGISTER CO. v. COMMISSIONER OF INTERNAL REVENUE

CIRCUIT COURT OF APPEALS, SIXTH CIRCUIT

Nov. 30, 1942

Before HAMILTON, MARTIN, and MCALLISTER, Circuit Judges.

MARTIN, Circuit Judge.

The taxpayer, Ohmer Register Company, has petitioned for review of the decision of the United States Board of Tax Appeals determining deficiencies in income taxes and excess profit taxes for the calendar year 1936. The petitioner is an Ohio corporation engaged in the business of selling cash registers and other products manufactured by the Ohmer Fare Register Co., a corporation which owns all of petitioner's capital stock.

Consistently since its organization in 1932, the petitioner has kept its books and rendered income tax returns upon the accrual basis. In determining the deficiency, the Board of Tax Appeals upheld the denial by the Commissioner of Internal Revenue of the right of petitioner to deduct from its gross income for 1936, as a regular and necessary item of business expense, a reserve for sales agents' commissions set up on its books as accrued and earned by its agents from sales made by them during 1936.

To clarify the issue presented, it is necessary to discuss in somewhat extended detail the rather complicated agreement between the petitioner and its sales agents. The form of agreement with its sales agents had been in constant use since the inception of petitioner's business in 1932, as like-

wise had been the method of bookkeeping for tax reference in use by petitioner during 1936.

Two instruments constituted the contract: an agreement known as "Form C-331" and an attached rider designated as "Rider 1-E." The sales agent's agreement, Form C-331, provided that the agent should receive as full compensation for his services and expenses a commission on monies received by the company from the sale of its products as stated in the attached rider, expressly made a part of the agreement; and that these commissions should be paid on the amounts of the total net sales, after deducting discount for quantity orders and for any other allowances to the customer, except cash discounts and "trade-in products" accepted on orders for Ohmer products and paid for by the agent as his property. Should the trade-in allowance not exceed the agent's advance commission, the amount allowed on the trade-in by him would be deducted from his advance commission on the sale; but, if the trade-in allowance exceeded the advance commission, the agent was required to send in to the company, with the order, his check for the difference between the amount of his advance commission and the amount allowed for the trade-in.

Should a purchaser countermand his order, refuse to accept the product ordered or deliver an exchange product as agreed, or tender a dishonored check; or should the company take back the product sold or commence repossession proceedings, the commission credited on the original transaction was required to be charged back to the agent's commission account. The agent's commission account would be credited with the proper rate of commission on the amount actually paid by the customer, if no reconditioning or repossession expense had been incurred and no refund to the customer made by the company. The agent's commission

account would be credited with the commission on the amount actually paid by the customer "after deducting the cost of reconditioning the register and/or cost of repossession."

The agent was required to create and maintain a competent, efficient and experienced Service Department and to have on hand at all times a sufficient stock of Ohmer repair parts "to keep all Ohmer products in his territory in satisfactory, efficient operation during the period of the company's guarantee thereon." It was agreed that, in consideration of the commissions to be paid to the agent, he would without charge repair at any time, in compliance with the company's regular guarantee, any Ohmer product "out of order from ordinary use," and in his prescribed territory would also repair any Ohmer product "on which there still remains a period of free repair."

Upon termination of the agreement, the agent's account would be settled by a determination, three months thereafter, of the amount still owing him on his sales; and a statement of his commission account showing commission credits, advances, charge-backs and miscellaneous credits and debits would be rendered. Similar settlements were to be made at subsequent intervals of three months. On this method of settlement, it was provided that if the credit balance of the agent on the books of the company should exceed the total possible commission charge-back, the difference would then be due and payable to the agent. If, however, at any such accounting period the agent's account should show him indebted to the company, he was required to pay the indebtedness immediately, or to make arrangements for its liquidation acceptable to the company.

Provision was made that the agreement in writing should constitute the entire contract between the parties;

and that the contract could not be changed, varied, modified or explained in any manner whatsoever, except by agreement in writing signed by a duly authorized executive of the company.

The foregoing constituted the pertinent provisions of the agreement known as Form C-331, which contained 34 numbered clauses. The attached Rider 1-E, expressly made a part of the contract, contained further pertinent provisions, which will be quoted:

"2. The following rates of commission will be credited to Agent subject to the remaining clauses of this Agreement on all Ohmer Cash Register orders received from Agent and accepted by Company after the effective date of this rider; * * * [advance commission (A) 10%, collection and service commission (B), at varying rates, are set out].

"3. To assist Agent in financing himself, the Company, after its acceptance of an order and after it has received the customer's signed delivery receipt and at least 10% cash with order, and so long as the condition of Agent's account and character of Agent's business warrants, will advance to Agent 10% of the net price of the register or registers after all deductions for discounts and other allowances (except cash discounts and trade-in allowances) have been made. In addition to the above 10% advance commission, the Company will pay Agent a collection and service commission as specified in column (B) above on the balance owing after 10% of the net price of the register or registers has been deducted, and after the money owing has actually been collected from the purchaser and received by the company. The acceptance of a promissory note by Com-

pany from a customer shall under no condition be considered as payment of customer's account."

The requirement that the agent should repair Ohmer Cash Registers and products was based upon the petitioner's contracts with its customers in connection with all deferred payment sales and frequently with cash sales, as well, to make free repairs for one year if the purchaser would pay transportation charges to and from the factory. The company was bound to fulfill its obligation to the customer in this respect, whether or not the sales agent fulfilled his assumed obligation to the company.

A sales contract, when signed by the purchaser, was forwarded to the petitioner for acceptance; and, when the merchandise was shipped, the full amount of the sales price was charged upon the petitioner's books to the customer's account and credited to gross income, whether the goods were sold for cash or on a deferred payment plan, evidenced by notes or otherwise. No book entry of sales was made until the goods were shipped. The total amount of the net sale, that is the actual amount to be paid by the customer after deducting cash discounts and trade-in allowances, was entered from the invoice, irrespective of the amount of cash received with the order.

The Board of Tax Appeals, in its findings of fact, has thus described the manner in which the petitioner made its bookkeeping entries with respect to its agents' commissions:

"After acceptance of the sale order and at the time of the shipment of the cash register sold, entries with repect to the transaction were made on petitioner's 'Commission Record,' under several headings or columns indicating, in substance, the following: Date of Sale, Name of Customer, Notes given and Trade-Ins, if any, Net Amount of Sale, per cent of commission as shown by the

sales agent's contract, Total Commission; and then under Current Commissions were placed Credits, Commission Earned, and in a second column under Current Commissions, were placed Debits, Check and Charge Backs, which were followed by the heading 'Reserve Commissions,' followed by 'Prospective Commissions,' which latter represent the difference between the total commissions and the amount credited under 'Current Commissions.'

"Commissions were figured at the contract rate upon the sale's price and entered upon the petitioner's record in column headed 'Total Commissions.'

"The commissions due the agent when a sale was made, accepted and 10 per cent of the selling price was actually received by the petitioner, were entered in the column of agent's account headed 'Current Commissions.'

"The aggregate total of the balances on the commission accounts of the sales agent was shown on the commission record as 'Prospective Commissions'; and 'Reserve Commissions' were carried on General Ledger Account No. 242-1, under the name 'Reserve for Sales Agents' Commissions,' which it was the practice of the petitioner to set up as a reserve (termed a misnomer by witness for petitioner) in each taxable year and claim a deduction therefor.

"The total commission column also was reflected in the general ledger, in account number 215, named 'Accounts Payable, Unpaid Commissions.'."

Some agents occasionally assigned their commission accounts as collateral to secure bank loans; and, in such instances, the petitioner accepted the assignments without guaranteeing payment of the loans, and issued checks covering the agents' commissions payable to the assignee. There were instances, also, where sales agents were paid their earned commissions before petitioner had received

payment from customers on orders upon which the commissions were earned.

The Board of Tax Appeals conceded the right of a taxpayer keeping books and filing income tax returns on the accrual basis, to deduct all ordinary and necssary expenses paid or incurred during the taxable year in carrying on any trade or business (Section 23 of the Revenue Act of 1936, Ch. 690, 49 Stat. 1648, 26 U. S. C. A. Int. Rev. Acts, page 827); and conceded, also, that the taxpayer may deduct, as expense incurred, a liability which has accrued during the taxable year, "although payment is not presently due." United States v. Anderson, 269 U. S. 422, 46, S. Ct. 131, 70 L. Ed. 347; American National Co. v. United States, 274 U. S. 99, 47 S. Ct. 520, 71 L. Ed. 946; Aluminum Castings Co. v. Routzahn, 282 U. S. 92, 51 S. Ct. 11, 75 L. Ed. 234. But, pointing out that except as otherwise specifically provided by statute, a liability does not accrue as long as it remains contingent (Weiss v. Weiner, 279 U. S. 333, 49 S. Ct. 337, 73 L. Ed. 720), that "reserves" have a definite meaning and limitation under the taxing statutes (Brown v. Helvering, 291 U. S. 193, 54 S. Ct. 356, 78 L. Ed. 725); and that, though a prudent business man often sets up reserves to cover contingent liabilities, such reserves are not necessarily allowable as deductions (Lucas v. American Code Co., 280 U. S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A. L. R. 1010), the Board held that the commissions in controversy "were not incurred and definitely fixed" during the taxable year so as to constitute an allowable deduction for income tax purposes, but, on the contrary, were mere "contingent liabilities" of the petitioner. Upon the principles of Brown v. Helvering, supra, the manner in which petitioner carried sales agents' commissions upon its books was deemed inconclusive of the

right to deduct. It was said that any system which accrues contingent liabilities as expense items does not correctly reflect, but distorts, income. Stating that United States v. Anderson, supra, involved "an unconditional liability," the Board held that the instant case involved contingent liabilities, in that all events which determined the liability of the petitioner to pay the sales agents' commissions had not occurred during the taxable year 1936, inasmuch as the commissions were dependent upon collection of the sales prices of the cash registers.

In urging reversal of the Board's decision, the petitioner insists that the items of commission expense set up on its books are not contingent, but are fixed, definite and accrued items of corporate liability, deductible as ordinary and necessary business expense under Section 23 of the Revenue Act; that, even if the liability of petitioner to pay the commissions is considered contingent, the same contingency exists with respect to the income from the identical transactions on which the commissions were earned; that, regardless of the question of contingency, the agents' commissions were never a part of income of the petitioner, but merely constituted funds passing through its hands as a conduit to the agents; and that the petitioner's method of accounting clearly reflects its true income.

The principles which this court applied in Air-Way Electric Appliance Corporation v. Guitteau, 6 Cir., 123 F. 2d 20, uphold the petitioner in the instant case upon its main contentions. Our conclusion from the findings of fact of the Board of Tax Appeals and the record before us is that both the petitioner and its agents have treated the agents' commissions as earned and as definite obligations of the petitioner entered as such on its books at the time goods were shipped pursuant to accepted orders.

Appendix C

The petitioner kept an "Agent's Commission Ledger Account" book, into which was entered under the heading "Total Commission" the full amount of an agent's commission immediately upon acceptance of a sales order received through him. Thus, the petitioner evidenced its recognition of a specific item of accrued expense as a fixed liability. The fact that the agent might not, in the end receive his full commission is no more material than that the petitioner might not receive full payment of the purchase price of the article sold. Petitioner's books were kept and its income tax returns were made upon the accrual basis.

The essence of the accrual method of keeping accounts and making returns is that the right to receive and not the actual receipt determines whether an amount should be included in gross income. The right accrues when the right to receive the amount becomes fixed. Spring City Foundry Co. v. Commissioner of Internal Revenue, 292 U. S. 182, 184, 54 S. Ct. 644, 78 L. Ed. 1200. Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike. Bonded Mortgage Co. of Baltimore v. Commissioner of Internal Revenue, 4 Cir., 70 F. 2d 341.

To divide the sales transactions here involved so as to treat them upon an accrual basis with respect to income and upon a cash basis with respect to expense in commissions in makng sales from which the income was derived would be as objectionable as the division condemned in Air-Way Electric Appliance Corporation v. Guitteau, supra.

Moreover, the mis-nomenclature in reference to the commission accounts, as described on the books of the peti-

tioner, is no more important to the determination of realities in this case than was the misdescription on the books of the company in the Air-Way case, where it was said: "It is true that the taxpayer styled its reserve account as a 'Reserve for Contingent Collection Expense,' but the mere designation of a reserve as based upon a contingency is not controlling if, in effect, it appears to be something other than a contingent obligation in the true sense." 123 F. 2d 23.

We see no valid reason for regarding the commissions as contingent liabilities rather than as definite obligations from the circumstance of inconsistent expressions in separate clauses of the agency contracts, wherein in one paragraph it is provided that the agent will receive as full compensation for his services and expenses "a commission on monies received by the company for the sale of its products," and in another paragraph it is said that "commission shall be paid on the amount of total net sales after deduction for quantity ordered and any other allowances."

The first mentioned clause would seem to concern the time when money may be demanded by the agent; the second, the amount of the commission payable. But, however that may be, both the petitioner and its agents have treated commissions as earned and as definite obligations of the petitioner, from the time the same have been entered on the books of the company.

In our judgment, the net income of the petitioner for the taxable year involved could not have been correctly determined upon the accrual basis, without deducting the commission expense from gross income. The method adopted clearly reflected the taxpayer's true income (American National Company v. United States, 274 U. S. 99,

47 S. Ct. 520, 71 L. Ed. 946), upon scientific accounting principles (United States v. Anderson, 269 U. S. 422, 440, 46 S. Ct. 131, 70 L. Ed. 347).

The items of commission expense claimed as deductible under Section 23 of the Revenue Act were not contingent liability but were definitely incurred and fixed liabilities within the taxable year.

The decision of the Board of Tax Appeals is reversed upon mandate that the deduction from petitioner's gross income for 1936 be allowed as prayed in the petition.

Form of Sales Agent's Agreement Involved in *Ohmer Register Co.* v. *Commissioner*

Form C-331
April 1, 1935

Contracting Parties

AGREEMENT, made this day of 19 between Ohmer Register Company, a corporation organized under the laws of the State of Ohio, and having its principal office at Dayton, Ohio, hereinafter called Company, and
hereinafter called Agent,

WITNESSETH:

Territory and Date Effective

1. The Company hereby appoints Agent as its sales agent for such Ohmer products as are specified in the rider or riders attached hereto and made a part hereof, effective , on the conditions herein set forth and within the territory described in said rider or riders.

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To Obey Rules, etc.

2. Agent will devote his time and best efforts to the furtherance of the Company's business in said territory as directed by its officers or representatives and will conform to and abide by its rules, price lists, decisions, and regulations now in force or as may be issued from time to time.

Confidential Information

3. Owing to the nature of Agent's position, Agent will acquire confidential information regarding the affairs of the Company, its plans, methods, customers, etc. Agent will not at any time disclose any part of such information to any person other than an authorized representative of the Company.

Prices and Orders

4. Ohmer products and supplies shall not be sold for more nor less than the current list prices fixed by the Company. All orders shall be taken upon the latest, proper printed forms as furnished by the Company and shall be sent to the Company, subject to its acceptance, the same day they are taken. All conditions and special agreements shall be specified thereon and the Company shall in no way be responsible for promises or conditions not specified on the orders. Agent agrees that any expense incurred by the Company by reason of a violation of these requirements, shall be borne by Agent.

Rates of Commission

5. During the continuance of this agreement Agent will receive, except as herein provided, as full compensation for Agent's services and expenses, a commission on

monies received by the Company from the sale of its products as stated in rider attached hereto and which rider becomes a part of this agreement. Commissions shall be paid on the amount of total net sales after deducting discounts for quantity ordered and any other allowances to the customer except cash discounts and trade-ins absorbed by Agent in accordance with Clause 6.

Trade-ins

6. All trade-in products accepted by Agent on orders for Ohmer products are to be paid for by Agent and shall become Agent's property. Each order must show the make, style, serial number and amount allowed on the trade-in. A bill of sale on each trade-in should be taken by Agent.

The amount allowed on the trade-in by Agent will be deducted from Agent's advance commission on the sale provided the trade-in allowance does not exceed the advance commission.

If the trade-in allowance exceeds the advance commission, Agent will send to the Company with the order his check for the difference between the amount of Agent's advance commission and the amount allowed for the trade-in.

Chain Stores, Etc.

7. The Company reserves to itself the right to handle direct, or through special representatives, all negotiations with and sales to concerns operating a chain of stores, and other quantity buyers, and to fix the rates of commission, if any, to be paid on such sales.

Cancellations

8. In case a purchaser countermands his order, refuses to accept the product ordered, refuses to deliver any ex-

change products as agreed or tenders a check which is later dishonored, or in case the Company takes back the product sold or commences repossession proceedings, the commission credited on the original transaction will be charged back to Agent's commission account. Agent's commission account will be credited with the proper rate of commission on the amount actually paid by the customer, provided no expense has been incurred by the Company in reconditioning or repossessing such product, or any part of the amount paid by the customer has been refunded by the Company. In such event, Agent's commission account will be credited with commission on the amount actually paid by the customer after deducting the cost of reconditioning the register and/or cost of repossession.

Past Due

9. Agent's commission account shall be debited with an amount equivalent to full rate of commission on the balance owing by customers on all accounts which become three (3) months or more past due. The Company reserves the right to debit Agent's commission account at any time with an amount equivalent to full rate of commission on the balance owing by any customer provided the Company believes that the account cannot or will not be collected. Commissions so charged back will be re-credited to Agent's account only when such customers' accounts are brought up-to-date in a manner acceptable to the Company.

Legal Expenses

10. All attorney fees and expenses incurred in the collection of any accounts for products sold by Agent, or for the recovery of such products, shall be divided between

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Agent and the Company, and Agent will pay, by having it charged to his account, the same percentage of such fees and expenses as was the percentage of commission credited to Agent on the sale of such products. Agent will attend the trial of cases whenever the Company considers his presence advantageous and and requests it.

Circularization Expenses

11. Agent will bear the cost of postage used by the Company on all circulars or advertising matter mailed to prospects in his territory.

Delay in Filling Orders

12. The Company will not be bound by any order until it is accepted at its home office by its authorized officers or their representatives. All orders it may accept will be filled by the Company as soon as possible in accordance with the instructions contained therein; but its failure or delay in filling an order from any cause shall not make the Company liable to Agent for any commission thereon.

Right to Fix Prices, Terms, etc.

13. The Company reserves the right at any time to fix or change the list price and the terms of payment, and the rate of commission and advance to be paid on any of its products.

Territorial Boundaries

14. Agent will not go beyond the boundaries of his territory for the purpose of selling Ohmer products except on the Company's written request or written approval.

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Disputed Commissions

15. Agent will abide by the Company's decision in the adjustment of commissions on any sales that may be in dispute between Agent and any other salesman, sales agent, dealer, or representative of the Company, and the decision of the Company shall be final.

Filing Liens, Adjustments of Accounts, and Making Collections

16. The Company shall have full control of and discretion as to the filing of liens and the collection, adjustment, or compromise of any or all accounts for products sold by Agent, but if the Company should request Agent to make any collections or to obtain possession of any property of the Company, whether it relates to a sale made by Agent or any sales representative that preceded Agent in his territory, Agent will do so promptly. The Company shall not be liable to Agent for any loss or commission or other claims, by reason of failure to file such liens, or by reason of any compromise or adjustment of any account or notes for products sold by Agent, or any failure for any reason to collect all or any part of any such accounts or notes.

Remittance to the Company

17. Agent will make daily remittances to the Company in the manner prescribed by it of all cash received by Agent for the Company, and in no event will Agent use any monies collected for the Company to defray his expenses or for any other purpose, or deposit them in any bank in his name. Agent will under no circumstances endorse any check or draft made payable to the Company. Agent will under no circumstances sign the Company's name to a receipt in full

for a customer's account, but instead Agent will receipt to the customer for the amount paid only, in his name as Sales Agent.

Service Repair Parts, Supplies

18. Agent will create and maintain a competent and efficient Service Department with experienced Ohmer servicemen, and will keep on hand at all times a stock of Ohmer repair parts sufficient to keep all Ohmer products in his territory in satisfactory, efficient operation during the period of the Company's guarantee thereon.

In consideration of the commissions to be paid to Agent, he will repair free of charge any products which may get out of order from ordinary use at any time, subject to the provisions of the Company's regular guarantee. Agent will also repair any product now in his prescribed territory on which there still remains a period of free repair.

In the event of the Company's receiving from Agent's territory a complaint as to the working of an Ohmer product, Agent will, upon request of the Company, go promptly to said complainant and if possible adjust the difficulty. In the event complaint is made to Agent directly by the user as to the working of a product sold by this Company, Agent will give it immediate attention, adjusting all difficulties involved, if possible, and reporting the matter to the Company.

Expenses

19. Agent will pay his own expenses, it being understood that the Company, is not to pay any of Agent's traveling, office, the cost of a license to do business, or other expenses, for all of which Agent expressly agrees to con-

tract in his own name, and under no circumstances to represent that the Company is responsible for such expenses. Agent will not sign the Company's name to any contract, agreement, lease, or other obligation whatsoever.

Casualty Insurance

20. The Company will not be liable for damages arising from the operation by Agent or any of Agent's employees or undersalesmen of any automobile or other vehicle which Agent may use in whole or in part in connection with his business as sales agent of the Company and Agent will carry adequate accident liability insurance covering any such automobiles.

Company Consignment Property

21. Agent will account for and deliver to the Company upon demand in good condition all products charged to him on consignment, also all price lists, decision books or any other property of the Company loaned to him or left in his care, and in case of failure to do this, the Company will have the privilege of charging them to his account at list price; but nothing herein shall prevent the Company from exercising legal remedies to recover possession of such property, and to punish those who wrongfully deprive it of possession thereof. Agent will not loan, or permit to be loaned, any new or second-hand products, other than those designated by the Company for that purpose. In the event that Agent should have consignment products on hand in his possession which have become unsalable as new, they may be ordered, at the discretion of the Company, returned to the factory or transferred to some other agency.

The Company may, at its discretion, furnish to Agent a consignment of Ohmer products sufficient for his needs,

the Company to decide his requirements. Agent will assume full responsibility for such Ohmer products as may be consigned to him and agrees to assume responsibility for the loss of such products so consigned and to compensate Ohmer for any damage (usual wear and tear excepted) which may occur to such products, including loss from fire, or from any other cause. Agent agrees to pay all taxes that may be levied on said consignment machines and agrees to forward to Company the receipts therefor. In case Agent does not promptly pay the taxes when due, Company is hereby authorized to pay them and charge them to Agent's Account.

Damage to Property

22. Agent will assume responsibility for any breakage or damage done to the property of the Company while it is in his charge, and all losses sustained by such breakage or damage shall be paid by Agent.

Fidelity Bond

23. Agent will furnish the Company upon signing this agreement a fidelity bond for faithful performance of his acts and duties and the proper and faithful account to the Company for all properties and monies entrusted to his care, said bond to be in such form and upon such conditions as the Company may require. All premiums on this bond are to be paid by the Company and will then be charged to Agent's commission account. Agent will also furnish to the Company upon signing this agreement fidelity bonds for each and every person in his employ having in their custody or handling any of the property or funds of this Company.

Application for such bonds must be forwarded to the

home office of the Company at the time of making this agreement, and at the time of employing any additional employees, said bonds to be in such form and upon such conditions as the Company may require. The expense of such bonds shall be borne by Agent. Agent will be responsible for any losses to the Company by reason of his failure to bond such employees.

Acceptance of Monthly Statements

24. Agent will waive all objections to monthly or other statements of accounts rendered by the Company unless written notice thereof is given by Agent and reaches the Company within thirty (30) days after rendition of the statement by the Company.

Claims Waived

25. Agent hereby waives all claims for commissions on sales or rentals, whether made by him or others, and all other claims of any nature whatsoever, if not made within one (1) year from the date of the termination of this agreement.

Records to be kept

26. Agent will keep such records and accounts as will properly show the status and progress of the agency created by this agreement and such records shall be open to the inspection of the Company's representatives. Among other necessary records Agent will keep an accurate record of sales made by him, showing the name and address of every customer, the kind of product sold, its date of delivery, factory number and the terms of the sale. Agent will keep a detailed and accurate record of all Ohmer inventory

on consignment and will mail to the home office of the Company not later than the fifth of each month a report of all products which may be in his office and in case any products are loaned to prospects, Agent will, when making his monthly report, list each of these products, stating the size, finish and factory number of the product thus loaned and the name, address and kind of business of the party who has the product in his possession. Agent will also keep an accurate record of the complaints received from customers in his territory and a complete file of service reports showing the service rendered and any charges which may have been made therefor.

Expense of Audit

27. The officers of the Company or its authorized representatives shall have the privilege of examining all books of accounts, vouchers and papers, in order that they may ascertain whether Agent's business is being conducted in a manner satisfactory to the Company. The expenses of any audit in Agent's territory by the Company's authorized representative shall be borne by the Company, but should an audit disclose any failure upon Agent's part to make proper account to the Company, as provided in this agreement, the expense of such audit shall be borne by Agent.

Outstanding Indebtedness

28. Agent hereby authorizes the Company, upon termination of this agreement, to pay any outstanding indebtedness incurred in Agent's territory and to charge it to his account; but the Company shall not be bound to pay any such indebtedness unless it shall elect to do so, and the payment of a part of Agent's indebtedness by the Com-

pany shall not raise any obligation on its part to pay the whole of said indebtedness. No assignment of any Agent's accounts, or any part thereof, shall be binding upon the Company unless it is accepted and acknowledged in writing by its Treasurer or other duly authorized officer of the Company.

Inventions

29. Agent agrees in part consideration of his appointment by the Company to assign to the Company any and all inventions and improvements he or those in his employ may conceive or make in the products of the Company during the life of this agreement and Agent specifically agrees that any and all inventions relating to any of the Company's products upon which he or those in his employ shall file an application or applications for Letters Patent of the United States or any foreign country within two (2) years after the termination of this agreement shall be conclusively presumed to have been conceived during the life of this agreement. Agent agrees to sign, or to cause those employed by him to sign, any papers and to do any acts which may be needful to secure to the Company or its successors or its assigns any rights relating to such inventions and improvements, including patents in the United States and any foreign countries.

It is hereby mutually understood and agreed between the parties hereto that for and in consideration of these premises, Agent is to receive no further compensation for such inventions and improvements as he or those employed by him, may make, assign and convey to the Company and for all of his or their rights, title and interest in and to any of them.

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Closing Out of Account

30. In the event of the termination of this agreement, the settlement of Agent's account shall be determined as follows: Three (3) months after said termination and at subsequent intervals of three (3) months thereafter, the amount still owing on sales made by Agent will be determined and a statement of Agent's commission account showing commission credits, advances, charge-backs, and miscellaneous debits and credits will be rendered. If Agent's credit balance on the Company's books exceeds the total possible commission charge-backs, the difference will then be due and payable to Agent.

If at the termination of this agreement or at any future accounting period Agent's account shall show an indebtedness to the Company, the amount thereof shall be immediately due and payable to the Company and Agent will immediately make acceptable arrangements with the Company for the liquidation of such indebtedness.

Waiver

31. Failure in any instance to enforce the condition of any part of this agreement shall not in any way invalidate or be deemed a waiver of any of the provisions contained herein.

Termination of Agreement

32. This agreement may be terminated by either party giving to the other written notice by mail or telegraph, addressed to such party at his last known address, or by personal delivery thereof.

All previous agreements between the parties hereto covering the distribution of Ohmer products are hereby superseded and canceled by this agreement, but the liquidation

of any account between Agent and the Company under any prior agreement shall be governed by the provisions of such prior agreement.

Laws of Ohio to Govern

33. All questions arising hereunder in any court of any state or of the United States or foreign country shall be decided according to the laws of the State of Ohio.

Modification of Contract.

34. It is understood and agreed that the contract between the said parties is fully and entirely expressed herein, and there is no parol or verbal contract, agreement or understanding of any kind whereby the terms hereof are or can be changed, varied, modified, or explained in any manner whatsoever, except by agreement in writing, signed by a duly authorized executive of the Company.

IN WITNESS WHEREOF, the said parties have executed this agreement in duplicate this .. day of ....., 19...

OHMER REGISTER COMPANY

By .....
Vice-President-Sales Manager

ACCEPTED:

.....
Sales Agent

Date ..... 19..

.....
Witness to Sales Agent's Signature

Appendix C

Form C-331-1E
April 1, 1935

Rider 1E to
SALES AGENT'S
AGREEMENT
CASH REGISTERS

Supplemental and without prejudice to the terms of the Sales Agent's Agreement, made by and between Ohmer Register Company, a corporation organized under the laws of the State of Ohio, and having its principal office at Dayton, Ohio, hereinafter called Company, and hereinafter called Agent, it is agreed by and between the respective parties to the above mentioned Sales Agent's Agreement dated as follows:

1. The Company hereby appoints Agent its exclusive Sales Agent for Ohmer Cash Registers on the conditions set forth in said Sales Agent's Agreement and within the following territory:

Agent's territory as herein described may be changed, enlarged or diminished at any time by Company's giving Agent written notice thereof.

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Agent is prohibited from soliciting sales beyond his territory as herein specified or as may be subsequently modified.

2. The following rates of commission will be credited to Agent subject to the remaining clauses of this Agreement on all Ohmer Cash Register orders received from Agent and accepted by Company after the effective date of this rider:

	Advance Commission (A)	Collection and Service Commission (B)
Classes 800 and 8000 A-300 and 3000 2700 and 2800		
New List	10%	31%
New Quantity Discount 10%	10%	26%
New Quantity Discount 10% and 5%	10%	23%
New Quantity Discount 10% and 10%	10%	20%
Second Hand	10%	25%
Classes B-300, 600 and 700		
New List	10%	26%
New Quantity Discount 10%	10%	21%
New Quantity Discount 10% and 5%	10%	18%
New Quantity Discount 10% and 10%	10%	15%
Second Hand	10%	20%

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	Advance Commission (A)	Collection and Service Commission (B)
Classes A-500, B-500 and C-500		
New List	10%	20%
New Quantity Discount 10%	10%	15%
New Quantity Discount 10% and 5%	10%	12%
New Quantity Discount 10% and 10%	10%	9%
Second Hand	10%	14%

3. To assist Agent in financing himself, the Company, after its acceptance of an order and after it has received the customer's signed delivery receipt and at least 10% cash with order, and so long as the condition of Agent's account and character of Agent's business warrants, will advance to Agent 10% of the net price of the register or registers after all deductions for discounts and other allowances (except cash discounts and trade-in allowances) have been made. In addition to the above 10% advance commission, the Company will pay Agent a collection and service commission as specified in column (B) above on the balance owing after 10% of the net price of the register or registers has been deducted, and after the money owing has actually been collected from the purchaser and received by the Company. The acceptance of a promissory note by Company from a customer shall under no condition be considered as payment of customer's account.

Above commissions apply only to sales made under this plan and after the date of this rider.

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4. On sales made on a cash basis to well rated concerns and where it is not possible to collect the minimum 10% cash with order, the Company, on acceptance of the order, will advance the regular 10% commission specified in column (A) above.

5. In the event of a repossession, Agent's commission will be recomputed and adjusted by applying the percentages of the advance commission (A) and the collection and service commission (B) as outlined in Clause 2 of this Rider 1E to the net amount actually received from the customer, after deducting any expenses for repossessing and for reconditioning the register.

6. On any blanket order for cash registers, commissions will be advanced or credited on each cash register only when and as actual delivery thereof is effected.

7. In the event Agent should fail to follow accounts and make collections when due, or should Agent fail to furnish service when requested, the Company at its option may send its representatives into Agent's territory to make such collections of accounts past due, and/or render necessary service, and it is understood and agreed that the expenses of such representatives shall be charged to Agent.

8. In the event of the cancellation of sales Agent's Agreement and of this Rider 1E, 10% of the outstanding customers' accounts in Agent's territory will be charged to Agent to compensate company for service as may be required on Company's products and for collections of customers' accounts.

9. The Company reserves the right at all times to deduct any amount Agent may owe the Company, or any

amount charged to Agent's account, from the amount then due and then payable to Agent and when making any settlement with Agent to forward only the net balance. In case there is no net balance, Agent agrees to pay Company promptly upon request the amount owing Company or charged by Company to Agent's account.

10. If an Ohmer product specified herein is sold by an Agent for delivery in another Agent's territory, the selling Agent will receive 40% of the commissions specified in columns (A) and (B) under Section 2 and in accordance with Section 3 of this rider and the Agent in whose territory the said product is to be used will receive the remaining 60% of the said commissions. Credit will not be received by the Agent in whose territory the product is used, however, unless Company requests Agent to install, instruct, and service the product during the guarantee period.

11. In the event of a transfer of an Ohmer product from one Agent's territory to another Agent's territory after delivery and installation has been made and prior to the expiration of the guarantee period, the commissions as outlined will be computed on a monthly basis in accordance with the unexpired time of the guarantee period.

12. On sales to chain stores and quantity users, and subject to the provisions of Clause 7 of Agent's Agreement, Company reserves the right to withhold payment of Agent's commissions until customers' accounts are paid in full. On sales made by others than Agent to chain stores and quantity users of Company products to be used in Agent's territory, upon which Agent is to receive commission credit,

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Company reserves the right to prorate any commissions as may be due Agent for registers delivered in Agent's territory, on a monthly basis over the guarantee period. In the event Sales Agent's Agreement is canceled at any time prior to the end of the prorata periods, no further payments of prorata commissions will be made to Agent and the unpaid balances of Agent's prorata commission credits will be debited to Agent's commission account.

13. Agent will buy Ohmer Cash Register repair parts as required from time to time at the Company's established list prices less a discount of 25% and pay for such repair parts on the basis of C.O.D. f.o.b. Dayton, Ohio, U. S. A., the only exception being electrotypes which will be subject to 10% discount. Agent will sell such parts to customers at the Company's established list prices.

14. All Ohmer Cash Register supplies ordered by Agent will be charged at Company's list prices less a discount of 25%, and Agent will pay for them on the basis of C.O.D. f.o.b. Dayton, Ohio. Agent will sell such supplies to customers at the Company's established list prices.

15. It is understood that Agent is to maintain accurate records of the balance due on Cash Registers from customers in Agent's territory and upon request by the Company to collect all payments on Ohmer Registers as they fall due and subject to Clause 17 of Sales Agent's Agreement.

16. This rider may be terminated at any time by either party giving notice to the other party.

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17. This agreement is to be considered as a rider to said Sales Agent's Agreement, to be attached thereto and become a part thereof, effective as of ....., 19...

OHMER REGISTER COMPANY

By .....
Vice President—Sales Manager

ACCEPTED:

.....
Sales Agent

Date ....., 19..

.....
Witness to Sales Agent's Signature

APPENDIX D

Opinion of the United States Court of Appeals for the Seventh Circuit in *Reineman* v. *United States*

HOWARD M. REINEMAN and HELEN REINEMAN,
Plaintiffs-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

United States Court of Appeals

Seventh Circuit.

April 6, 1962.

Before HASTINGS, Chief Judge, and DUFFY and SWYGERT, Circuit Judges.

HASTINGS, Chief Judge.

This is an appeal by the Government from a judgment in the amount of $76,052.60 with interest, entered in favor of plaintiffs[1] (taxpayers) in a suit for refund of overpayment of personal federal income tax for the year 1954.

The case was tried to the court without the intervention of a jury. The district court sustained taxpayers' claim that the entire cost of six thoroughbred brood mares over age ten purchased by taxpayers in November and December, 1954 for $102,608 was deductible in full in the

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[1]Taxpayers Howard M. Reineman and Helen Reineman are husband and wife and filed a joint federal income tax return for the year 1954, the taxable year in question.

year of purchase, as depreciation "of property used in the trade or business."[2]

The district court also sustained taxpayers' claim that the deficiency assessment which gave rise to the overpayment should be set aside because the Commissioner made a second inspection of taxpayers' books of account for the year 1954 without giving taxpayers prior written notice as required by Section 7605(b), Internal Revenue Code of 1954.[3]

Brood mare sales are held each year in October, November and December. The breeding season runs from February 15 to June 15, and the gestation period for a foal is 340 days. The custom in the thoroughbred industry, recognized by the Government, is that all thoroughbreds have a birth date of January 1. One year is added to the age of each thoroughbred brood mare on January 1 of each year without regard to the month of birth.

Taxpayers started in the business of raising thoroughbred horses in 1942 with a small stable of race horses. Their operations grew until in 1948 they were in the business of breeding race horses on a large scale.

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[2]Int. Rev. Code of 1954 § 167(a), 26 U. S. C. A. § 167(a) provides: "(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income."

[3]"No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary." Int. Rev. Code of 1954, § 7605(b), 26 U. S. C. A. § 7605(b).

Appendix D

In 1954, taxpayers owned approximately one hundred brood mares, ranging in age from two to twenty years. In 1954, they purchased ten additional brood mares, ranging in age from six to twenty years. Seven of these brood mares were over age ten at the time of purchase.[4] They were placed in the herd with the other one hundred brood mares owned by taxpayers. During the years 1949 to 1953 inclusive, taxpayers had purchased twenty brood mares over age ten for a total cost of $150,416.67.

With respect to taxpayers' adoption of a ten year useful life for all horses in their stable, the dictrict court found that:

> "[P]laintiffs consulted and followed the only guide to depreciation of horses, Bulletin F, I. R. S. Publication No. 173. * * * The plaintiffs sought the advice of tax counsel and a Certified Public Accountant and were directed to the Carson Tables, published by the Commerce Clearing House, in the magazine Taxes, August 1948, * * * and a book 'Racing and Income Tax' published by the National Thoroughbred Foundation * * *. The plaintiffs, adopting the recommendations contained in all of these publications and relying on Government Bulletin F, and with the advice of their tax counsel, who had the benefit of the experience of others in the breeding business, consistently used the same rates for depreciation of horses through that period. Spe-

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[4]One of the seven mares over age 10 at the time of purchase was Gulf Breeze, age 20. Taxpayers paid $10,000 for her on December 9, 1954 and claimed the full cost as depreciation in 1954. The Government does not contest the depreciation claimed on this mare. The remaining six mares over age 10 are concerned in this appeal. The aggregate cost of the six mares was $102,608.

cifically; race horses—10 years; brood mares—10 years. * * *"

A ten year useful life was adopted for all horses regardless of productivity or of age at the time of acquisition. The six brood mares in question were over age ten when purchased in 1954 and taxpayers, applying a ten year useful life, deducted the entire cost on their 1954 income tax return. This followed a practice consistently used by taxpayers since 1942 and never before challenged by the Internal Revenue Service.

This deduction was disallowed by the Commissioner on the ground that the six mares in question had a probable useful life of sixteen to seventeen years, and further that since the mares were purchased in November and December, 1954, only two-twelfths or one-twelfth of the annual amount was deductible in that year.

We are faced with two issues in this appeal. The first relates to whether the entire cost of the six brood mares in question was properly deducted as depreciation in the year of purchase (1954) by taxpayers. The amount of depreciation allowable is not in dispute. It is agreed that taxpayers may deduct the full purchase price of the mares. It is merely a question of timing—when may the cost be properly claimed?

The second issue relates to the correctness of the finding and holding of the district court that the deficiency assessment must be set aside because the Commissioner made a second inspection of taxpayers' 1954 books of account without notifying taxpayers in writing as required by Section 7605(b), supra.

Since our resolution of the second issue is dispositive of this appeal, we first give it consideration. On this ques-

tion, the district court entered the following findings of fact:

"2. The plaintiffs filed a timely joint Federal Income Tax Return (Form 1040) for the taxable year 1954 on or about March 11, 1955, with the District Director of Chicago, Illinois and paid the tax determined thereon; a copy of the Federal Income Tax Return, Form 1040, was introduced in evidence. (Plaintiffs' Exhibit 10).

"3. The Commissioner of Internal Revenue by his agent, Louis Locsmandy, caused the aforesaid return, and the books and the records reflecting depreciation taken on thoroughbred horses for the year 1954 to be examined on November 27, 1956, and as a result of said examination a deficiency was found in the amount of $2,091.14. Said deficiency being satisfied on March 20, 1957.

"4. During the month of August, 1957, the plaintiffs were notified by Harold Rogers, another agent of the Internal Revenue Service, that he was assigned to audit plaintiffs' 1955 books and records. Agent Rogers did not request an audit of plaintiffs' 1954 books and records.

"5. Plaintiffs first learned that their 1954 return had been reopened by Agent Rogers when they received in the mail plaintiffs' Exhibit 3, a ten-day letter.

"6. On October 4, 1957, plaintiffs protested a second examination of their 1954 books and records by letter to the Internal Revenue Service in Lexington, Kentucky (Plaintiffs' Exhibit 4).

Appendix D

"7. The plaintiffs did not consent to Agent Harold Rogers' inspection and examination. No re-examination was requested by the plaintiffs nor did the Secretary nor his delegate notify the plaintiffs in writing that an additional inspection was necessary. Agent Harold Rogers could not have prepared his detailed adjustments of all horses acquired in 1954 without an inspection and examination of plaintiffs' 1954 accounts and records. (Plaintiffs' Exhibit 2)."

Agent Rogers did not testify at the trial. The Government took his discovery deposition and introduced it at the trial. The burden of Rogers' testimony in his deposition is that, although he reopened the year 1954, he made no examination of taxpayers' books and records. He stated in effect that he got the information and data necessary to prepare his computation of allowable depreciation expenses for the year 1954 "from the taxpayer's accountant's work papers for the year 1955 and subsequent year." These were made available to him by the accountant. The work papers were not produced at the trial.

The computation by Agent Rogers is shown as Plaintiff's Exhibit 2 and reads:

PLAINTIFF'S EXHIBIT 2

(U. S. Treasury Department—Internal Revenue Service)

(COMPUTATION OF ALLOWABLE DEPRECIATION EXPENSE)

Form 1914
Apr. 1954
Exhibit A

Howard M. & Helen S. Reineman 1954

*Kind of property

(If buildings, state type of construction. Exclude land and other non-depreciable property)

Kind of Property	(Age)	Date Acquired	Cost or Other Basis	Depreciation Allowed or Allowable In Prior Years	Remaining Cost Or Other Basis To Be Recovered	Life Used In Accumulating Depreciation	Estimated From Beginning Of Year	Depreciation Allowable This Year	
Bibijon	(13)	11-1-54	5,000.00	—0—	5,000.00	17 Yrs.	4 Yrs.	(2/12)	208.33
Monsoon	(13)	12-2-54	44,100.00	—0—	44,100.00	17	4	(1/12)	918.75
Linaria	(11)	12-8-54	30,870.00	—0—	30,870.00	16	5	(1/12)	514.50
Maintenon	(13)	12-8-54	12,936.60	—0—	12,936.00	17	4	(1/12)	269.50
Market Basket	(12)	12-9-54	5,292.00	—0—	5,292.00	16	4	(1/12)	110.25
Tilly's Last	(11)	12-9-54	4,410.00	—0—	4,410.00	16	5	(1/12)	73.50
Totals			102,608.00		102,608.00				2,094.83

*Broodmares

Total Depreciation Expense Allowable 2,094.83
Depreciation Expense Claimed 102,608.00
Increase/(Decrease) 100,513.17

Appendix D 7d

Appendix D

At the trial, Mr. Reineman testified as follows:

> "By Mr. Devitt:
>
> "Q. Now, Mr. Reineman, from your experience and your knowledge of your books and records, the filing of your 1954 return, would it be possible that Agent Rogers could have made the depreciation adjustments without the names and dates taken from your 1954 books of account?
>
> * * *
>
> "The Witness: There is no way that it could have been done. It is inconceivable.
>
> "By Mr. Devitt: Q. In other words, for Mr. Rogers to have prepared Plaintiff's Exhibit 2, recomputation of allowable depreciation for the six broodmares in question he would have had to examine—
>
> "By the Witness: A. He had to reopen 1954 and examine the records.
>
> "Q. He couldn't obtain that information from your 1954 return?
>
> "A. It is not on there, sir."

Taxpayers' 1954 tax return was in evidence and the depreciation allowance claimed was shown in a two line table of composite figures without any detailed specification of the horses and mares involved.

Several inescapable inferences may be drawn. Agent Rogers could not have obtained his information from the 1954 tax return. The entire cost of the six brood mares was charged off in 1954. It is reasonable to conclude that the data as to these mares would not be necessary to the preparation of taxpayers' accountant's work papers for

1955 and subsequent years. Rogers had access to taxpayers' books of account for 1955 and subsequent years. He made no claim that he got the 1954 information from them. Rogers' deposition is lacking in specifics and the trial court was justified in crediting Reineman and rejecting Rogers.

The Government does not contend that the Commissioner compiled with Section 7605(b). It first urges that the material findings on this issue are not supported by the record and are clearly erroneous. We do not agree. There was a conflict between taxpayer and Agent Rogers. The trial court resolved such conflict in favor of taxpayer. This was within the province of the hearing tribunal. *National Labor Relations Board* v. *Aurora City Lines, Inc.*, 7 Cir., 299 F. 2d 229 (1962). We hold that such findings are not clearly erroneous but are amply supported by the record. Rule 52(a), Federal Rules of Civil Procedure, 28 U. S. C. A.

The Government finally contends that the district court erred as a matter of law in invalidating the deficiency assessment as a result of a found violation of Section 7605(b). It asserts that taxpayers' "remedy is one of self-help—he may refuse to permit the subsequent examination and oppose the director's application for a subpoena." The short answer to this is the taxpayers had no opportunity for self-help. Agent Rogers never made any pretense that his assignment was to reopen the year 1954 or to reaudit the books of account for that year. It is agreed that taxpayers' first knowledge that Agent Rogers was reopening 1954 was their receipt of the ten-day letter. Taxpayer was totally unaware of any re-examination, while it was in progress. Subsequent to receipt of the ten-day letter, following taxpayers' protest, they were advised by the Internal Revenue Service that a reexamination was not necessary.

There is no contention of fraud or any conscious action on the part of taxpayers to mislead anyone. It is conceded that taxpayers acted in good faith and that their claim of depreciation was fully consistent with the method used in prior years.

In support of its position, the Government cites *Philip Mangone Co.* v. *United States,* Ct. Cl., 54 F. 2d 168 (1931); *Executors of Estate of Barker* v. *Commissioner,* 13 B. T. A. 562 (1928); *McDonnell* v. *Commissioner,* 6 B. T. A. 685 (1927). These three cases and others of similar tenor[5] involve instances where taxpayers either failed to object or voluntarily consented to a re-examination. Under such circumstances, the courts have properly held that taxpayers have waived their rights under the statute.[6]

The question of the relief to be granted a taxpayer for a violation of Section 7605(b) with a resulting deficiency assessment appears to be essentially one of first impression. No case has been cited, and our research has revealed none, where a deficiency assessment under this situation has been either upheld or invalidated.

Under the facts of this case, taxpayers are left without any remedy to correct the illegal action taken by the Commissioner unless the deficiency assessment is set aside. We hold that the district court did not err in its conclusion of law to that effect.

In view of the foregoing, we do not reach and pass upon the question concerning the period in which the depreciation should be claimed.

The judgment of the district court awarding refund as entered below is affirmed.

Affirmed.

---

[5]*United States* v. *O'Connor,* 2 Cir., 237 F. 2d 466 (1956); *Glassell* v. *Commissioner of Internal Revenue,* 5 Cir., 42 F. 2d 653 (1930); *Haun* v. *Commissioner,* 13 B. T. A. 297 (1928).

[6]See 8 Mertens, Federal Income Taxation § 47.48 (Zimet Rev. 1957).

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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 661

FIELD ENTERPRISES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. 1a–10a) is reported at 348 F. 2d 485.

JURISDICTION

The judgment of the Court of Claims was entered on July 16, 1965 (Pet. 41a). The petition for a writ of certiorari was filed on October 12, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether the Commissioner correctly refused to permit an accrual basis taxpayer to deduct amounts

representing an estimate of its liability to its managers for so-called "quality bonuses."

2. Whether the failure of the government to provide petitioner with prior written notice of a second inspection of its 1955 books and records pursuant to Code § 7605(b) invalidates a deficiency assessment for fiscal 1955, where the second inspection of petitioner's 1955 books (which were voluntarily turned over) was incident to a necessary examination of its 1956 books.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

[26 U.S.C. 461.]

SEC. 7605. TIME AND PLACE OF EXAMINATION.

* * * * *

(b) *Restrictions on Examination of Taxpayer.*—No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

[26 U.S.C. 7605.]

Treasury Regulations on Income Tax:

> SEC. 1.461–1(a)(2). * * * Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * *

STATEMENT

This case presents two discrete issues, one substantive and the other procedural. The first is whether, under petitioner's newly adopted method of compensating its salesmen and sales managers, it is entitled to accrue and deduct in fiscal 1955 and 1956 amounts representing estimated quality bonuses payable in the future. If, as the government contends, the deductions were not proper, the second issue is whether the deficiency notice for fiscal 1955 is defective for procedural reasons.

1. Petitioner published and sold encyclopedias ("World Book" and "Childcraft") door to door, receiving payment in installments. Prior to petitioner's fiscal year 1955, all salesmen and regional and district managers were compensated solely by means of a specified commission payable on each "bona fide" sale. A sale became "bona fide" when the customer paid a specified amount ($30) within a specified time (15 months). Salesmen were given advances against future commissions, but petitioner was not obligated to pay any commission on an order until it became "bona fide." Under this method of paying commissions petitioner did not accrue commission expense for federal tax purposes until the

bonafication period had expired, since petitioner recognized that until the bonafication requirement was satisfied "the commission might never actually become a liability."

Under new contracts effective at the beginning of fiscal 1955 the salesmen's commissions were reduced slightly in amount but were made payable immediately upon acceptance of the order. Managers likewise received slightly reduced commissions payable immediately upon acceptance of an order,[1] but managers also became entitled to a new item of compensation, called a "quality bonus" (the deductibility of which is here in question). The total amount of commissions and quality bonuses under the new contracts was equal to the total amount of commissions payable under the old contracts, *i.e.*, $49.

A quality bonus was computed as follows: At the time a sale was made the district and division managers' accounts were tentatively credited with a total of $7. If the customer did not make at least two of the first six required monthly payments, the managers accounts would be charged for $49. At the end of each three-month period the managers would be paid a

[1] Because the commissions under the new contracts were payable upon acceptance of the order, petitioner was entitled to a tax deduction much sooner than under the old contracts. Indeed, in fiscal 1955, petitioner was able to deduct commissions on sales orders accepted during that year under the new contracts, as well as commissions on orders accepted in earlier years which became bona fide in that year under the old contracts. The Court of Claims found that the tax saving caused by the accelerated deductibility of commissions was one of the reasons which prompted petitioner to change its system of compensation. (Pet. 22a.)

quality bonus if their credits in this account exceeded the charges for that period. Of course, a slight variation in the percentage of orders becoming bona fide would have a greatly magnified effect on the managers' quality bonuses, because the managers had a potential credit of $7 for each successful sale as opposed to a net charge of $42 ($49 charge less $7 credit) for each aborted sale.

Petitioner sought to deduct in each of its fiscal years 1955 and 1956 an estimated amount representing quality bonuses it expected to pay in the future on sales already contraced but not yet bona fide. This was computed by taking the amount of quality bonuses tentatively credited to managers and deducting an estimated amount which petitioner, on the basis of its experience, expected to be charged against managers in the future for those sales already contracted which would not become bona fide. The Internal Revenue Service disallowed the claimed deduction for estimated future quality bonuses.

2. In March, 1957, a revenue agent audited petitioner's fiscal 1955 federal income tax return. He had not previously audited petitoner and was unfamiliar with the voluminous records it maintained. He inquired concerning petitioner's $14,867,640 deduction for salaries and wages (which *sub silentio* included the claimed deduction for estimated future quality bonuses). Petitioner supplied the agent (1) with a written explanation of the new contracts which did "not mention the 'quality bonus'" and (2) with a copy of a salesman's, but not a manager's, contract (only managers' contracts mentioned quality bonuses). There-

fore, the agent never learned of the existence of petitioner's new quality bonus system.

In August, 1958, another revenue agent (Miss Mortenson) commenced an examination of the petitioner's fiscal 1956 return. She requested and received a full set of new contracts, including those with managers which provided for quality bonuses. During the course of her examination, petitioner voluntarily made its records for fiscal 1955, as well as for fiscal 1956, available to her so that she could understand the 1956 opening balances and the working of the new quality bonus system. She then raised questions concerning the proper time for accruing quality-bonus deductions with petitioner's representatives, and in October, 1958, Agent Mortenson asked petitioner's representatives to consent to an extension of the period of limitations on the assessment of deficiencies for fiscal 1955, which would otherwise expire on December 15, 1958. Petitioner's representatives refused. On December 11, 1958, the Commissioner served petitioner with an official written notice that a re-examination of its fiscal 1955 return would be made, and, on the following day, a statutory notice of deficiency for that year was issued. (Pet. 1a-41a.)

ARGUMENT

1. *Premature Accrual of Deductions for Quality Bonuses.* The decision of the court below on the accrual of quality bonuses is correct, the case turns on its peculiar facts, and there is no conflict of decisions.

The issue presented here is solely one of timing, *i.e.* whether petitioner is entitled to a deduction for quality bonuses at the time of each sale or at the end of

the bonafication period. All the courts to pass on such questions (including the lower court in the instant case) agree on the controlling legal principles. Petitioner is entitled to deduct accrued quality bonuses in "*the taxable year in which all the events have occurred which determine the fact of the liability* and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461–1(a)(2) (emphasis added). However, no deduction will be allowed for an estimated future expense before it becomes a fixed liability. *Brown* v. *Helvering*, 291 U.S. 193. This case involves the application of these settled principles to petitioner's unusual quality-bonus system.

Petitioner sold most of its encyclopedias on the installment method. Under the quality-bonus system its sales managers would receive a bonus only if the vast majority of sales in their area were substantially completed rather than aborted after a few payments.[2] The purpose of the system was to encourage the managers to train and supervise their salesmen to concentrate on making sales that would be substantially completed. The managers were given a quality bonus of $7 for each sale that became bona fide (*i.e.*, upon which the requisite number of payments were made) and were penalized $42 for each sale that did not reach the requisite stage of maturity. Thus, the managers as a group would not receive a quality bonus

[2] Petitioner's quality bonus system is tailored to its highly unusual method of doing business. Petitioner employed more than 20,000 part time salesmen and paid them a 32% commission upon the makings of a sale requiring only a $10 down payment. Thus petitioner felt that its quality bonus system would encourage close managerial supervision of its large part-time sales force in order to avoid carelessness and possible fraud.

unless more than 6 sales became bona fide for every one that aborted. The quality-bonus system was carefully designed to compensate the managers not on the basis of individual sales, but on the basis of the overall performance of their territories during an extended period of time. Because of the interrelationship between the sales in determining the amount of the bonus—each sale which aborted before the requisite payments were made washed out the quality bonus otherwise payable on 6 sales which actually became bona fide—it was impossible to determine whether there would be any quality bonuses until 6 months after the sales were made—*i.e.*, the end of the bonafication period. On these facts the lower court correctly concluded that petitioner's liability for a quality bonus was not fixed at the time of a particular sale, but that because of the interrelationship between transactions the liability for a bonus did not become fixed until expiration of the six-month bonafication period.[3]

---

[3] In fact, petitioner acknowledged that its claimed deduction was merely a statistical estimate of the amount it would have to pay as quality bonuses. It sought a deduction for accrued quality bonus credits which had not, at the end of its fiscal year, become bona fide, less an estimated amount which, on the basis of its experience, it expected to charge against managers in the future for sales which would not become bona fide. This Court has recently held that the Commissioner need not accept such estimates in computing taxable income (*American Automobile Assn.* v. *United States*, 367 U.S. 687), and the same principle applies to deductions. *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, *per curiam*, vacating and remanding 283 F. 2d 279 (C.A. 7), 293 F. 2d 628 (C.A. 7), certiorari denied, 368 U.S. 976; see *Simplified Tax Records, Inc.* v. *Commissioner*, 41 T.C. 75, 79.

Petitioner claims that the instant decision conflicts with *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (C.A. 6). That case involved ordinary sales commissions, and is thus radically different than the instant case. The Ohmer Register Co. credited each salesman with a commission based on the amount of each sale made by him. If the customer breached the contract after making only part payment, the salesman's account would be charged with a pro-rata portion of the commission. Under this system the salesman's commission was computed separately on each sale. The court thus held that as each sale was made, Ohmer's liability for a commission on that sale became fixed, and that the possibility that the buyer's later breach might affect the amount of the commission on that sale should not defeat accrual.

Both the lower court in the instant case and the court of appeals in *Ohmer* agreed on the controlling principles of law. Only because petitioner's unusual quality-bonus system was so radically different from the ordinary sales commissions in the *Ohmer* case did the lower court find that petitioner was not entitled to a deduction. Indeed, the Court of Claims in the instant case pointed out the crucial factual difference:

> * * * [I]n *Ohmer,* each individual order (upon shipment) gave rise to liability for a commission. With regard to the case at bar, we have already indicated that a quality bonus was based not upon an individual sale, but upon the overall experience within the manager's territory for a given quarter. * * * [Pet. 5a–6a.]

There is thus no conflict between cases like *Ohmer* dealing with ordinary salesmen's commissions and the instant case.

If petitioner had agreed to pay its managers a bonus based on its net income for the year 1955, it would not have been entitled to accrue a deduction as it made each individual sale. See *Kaufman Dept. Stores, Inc.* v. *Commissioner*, 34 F. 2d 257 (C.A. 3). The net profit on a dozen advantageous sales may be offset by the loss on a single disadvantageous transaction. In computing a bonus based on the net profit for an entire year, the necessary interrelationship between all the transactions for that year prevents the liability from being regarded as fixed as each separate sale occurs. Only at the end of the year can a bonus based on net profits be accrued. In terms of this crucial factor—*i.e.*, the interrelationship between transactions—petitioner's quality-bonus plan was much closer to a bonus based on net income than it was to an ordinary salesman's commission (which, as in *Ohmer*, can be computed separately on each sale). The lower court was, therefore, correct in deciding that petitioner's liability could not be regarded as fixed until the expiration of the six-month bonafication period.

The court's decision turns on the peculiar facts of petitioner's unusual quality-bonus system. There is no disagreement on the applicable legal principles and no conflict of decisions.

2. *Validity of the 1955 Deficiency Notice.* The decision of the lower court on this procedural issue (relating only to the fiscal 1955 deficiency) is correct,

and there is no direct conflict with any appellate decision.

Section 7605(b) of the Code provides that:

> * * * only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an added inspection is necessary.

Petitioner contends that the section must be read literally to prohibit Agent Mortenson from inspecting petitioner's 1955 books (during her audit of petitioner's 1956 return), because they had previously been inspected by another agent; that petitioner's decision to voluntarily give its 1955 books to Agent Mortenson should not constitute a waiver; and that the Court should read into the section an additional provision that any deficiency notice based on information obtained in violation of § 7605(b) is invalid. We disagree with all three contentions.

The purpose of § 7605(b) was to prevent taxpayers from suffering "petty annoyances" due to frequent re-examination of their books by low-echelon revenue agents. 61 Cong. Rec. 5855, quoted in *United States* v. *Powell*, 379 U.S. 48, 54–55. Viewed in this light, it is, we submit, clear why Congress did not provide any sanction for violation of the section. If a taxpayer was "annoy[ed]" by a revenue agent's request to re-examine his books, the taxpayer could refuse to produce them. The agent would then have to get clearance from his superior (*United States* v. *Powell*, *supra*, at 55–56) or drop the request. The taxpayer

could defeat any attempt to subpoena the records without a re-examination letter by merely citing § 7605(b) to the enforcing court. See *McDonnell* v. *Commissioner*, 6 B.T.A. 685; *Philip Mangone Co.* v. *United States*, 54 F. 2d 168 (Ct. Cl.); *Glassell* v. *Commissioner*, 42 F. 2d 653 (C.A. 5); *Sutor* v. *Commissioner*, 17 T.C. 64; *Rife* v. *Commissioner*, 41 T.C. 732. If, on the other hand (as in the instant case), the agent's examination did not "annoy" the taxpayer, § 7605(b) is never called into play. We submit that § 7605(b) was never intended to invalidate a correct deficiency notice, but merely to *permit* a taxpayer who wishes to do so to refuse an agent access to records that have once been examined, unless a supervisor approves.[4]

The vast majority of the courts have construed § 7605(b) as meaning no more than that a taxpayer who is annoyed by a re-examination may, if he asserts his right, refuse the agent access to his books. See

[4] Moreover, in the instant case a re-examination letter was served on petitioner before issuance of the deficiency notice. Certainly Congress did not intend § 7605(b) to mean that if Agent Mortenson (the second agent) examined petitioner's 1955 books without having first obtained a re-examination letter, the Service would be forever barred from issuing such a letter and again re-examining petitioner's 1955 books. Therefore, if, after issuance of the re-examination letter on Dec. 11, 1958, Agent Mortenson had again examined petitioner's 1955 books and obtained the information necessary for the deficiency notice, petitioner could not invoke § 7605(b) to invalidate the deficiency. It would exalt form over substance to hold the deficiency notice invalid because Agent Mortenson did not perform the unnecessary task of again re-examining petitioner's books after service of the re-examination letter, but instead used the information gathered before issuance of the letter.

cases cited *supra*, p. 12. Only the Seventh Circuit has departed somewhat from this rationale, *Reineman* v. *United States*, 301 F. 2d 267 (C.A. 7), and its decision is not in conflict with the instant case. In *Reineman* one revenue agent had fully examined the taxpayer's 1954 return. Another agent, during a subsequent examination of taxpayer's 1955 return, looked at taxpayer's 1954 books without taxpayer's knowledge, and assessed a deficiency for 1954. The court held the deficiency notice invalid because the second agent had violated § 7605(b). While we do not agree with the decision (for the reasons stated *supra*, pp. 11–12), it is clear that the Seventh Circuit would not have quashed the 1955 deficiency notice issued to petitioner. In its *Reineman* opinion that court stated that it fully agreed with the numerous cases (cited *supra*, p. 12) holding that where taxpayers knew that the second agent was looking at their books for the earlier year (here 1955) and "either failed to object or voluntarily consented," then the "taxpayers have waived their rights under" § 7605(b). 301 F. 2d at 272. However, the court stated that Reineman had been "totally unaware" that the second agent was looking at his 1954 books. *Id.* at 271. Finally, the Seventh Circuit noted that Reineman had not engaged in any "conscious action * * * to mislead" the first agent who had examined his 1954 books.

The instant case is thus distinguishable from *Reineman* on two grounds that the Seventh Circuit thought crucial. Petitioner "voluntarily furnish[ed] * * * its 1955 records" to Agent Mortenson (the second agent) (Pet. 10a). And partially because of

petitioner's failure to make full disclosures in reply to the first agent's questions, he had "not actually learn[ed] of the existence of the [new] quality-bonus system" (Pet. 10a). Therefore, while the Seventh Circuit's *Reineman* decision is not completely consistent in principle with the vast majority of the decisions on § 7605(b), the Seventh Circuit would nevertheless have reached the same correct result as the lower court.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 661

FIELD ENTERPRISES, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

REPLY TO BRIEF FOR RESPONDENT

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IN THE

Supreme Court of the United States

October Term, 1965

FIELD ENTERPRISES, INC., *Petitioner,* *v.* UNITED STATES OF AMERICA, *Respondent.*	No. 661

REPLY TO BRIEF FOR RESPONDENT

1. *Accrual of Deductions for Sales Commissions.* Respondent agrees that under *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (6th Cir. 1942), a taxpayer may accrue sales commissions at the time of sale even though they will not be paid if the purchaser defaults in his installment payments, or if previously paid will be repaid in cash upon such default. (Pet. 6; Resp. 9.) Nevertheless, respondent purports to distinguish *Ohmer* from the decision below because petitioner, having paid $42 of the $49 commission at the time of sale and credited the $7 balance (called the quality bonus), may in the event of the purchaser's default recover the $42 through charges against other quality bonuses instead of requiring repayment in cash. (Resp. 7; see Pet. 4.) Thus, respondent would limit petitioner's accrual to $42 while conceding that the entire $49 would be accruable at the time of sale (1) if the entire payment were deferred and would never be made if the purchaser defaulted or (2) if all or a portion were paid at the time of

sale subject to repayment in cash upon the purchaser's default.

Respondent argues that petitioner's method of recovering the $42 paid on sales that later defaulted turned the $7 quality bonus portion of each commission into compensation based on overall performance instead of on individual sales. (Resp. 7-8.) This overlooks the fact that petitioner's commission liability on every bona fide sale was $49, just as it would have been if petitioner had settled with its salesmen in either of the other ways described above. However petitioner settled with its salesmen, the $49 commission on each sale was a fixed obligation unless the purchaser defaulted; it was therefore, a "fixed liabilit[y] within the taxable year" of sale under the *Ohmer* decision, 131 F.2d at 686.

Although respondent calls petitioner's commission system "peculiar" and "unusual" (Resp. 10), the fact is that subscription reference book sellers generally make sales commissions on installment sales dependent on payment by the purchaser of his installment obligations. Approximately 80 percent of sales of such books, which amounted to $410,-800,000 in 1964, are made on the installment basis. Appendix A, *infra*. Other important industries also sell their products on the installment basis under similar commission arrangements. The members of these industries are now faced with conflicting rules for accrual of their sales commissions. (Pet. 6-7.) Sound and equitable tax administration requires that this Court resolve the conflict.

2. *Unauthorized Reexamination.* Respondent attempts to distinguish the decision below from *Reineman* v. *United States*, 301 F. 2d 267 (7th Cir. 1962), on grounds that are irrelevant to the question of law on which the two decisions conflict. (Resp. 13-14.) What the two courts disagreed on was the legal question of whether—if a viola-

tion of the written notice requirement of section 7605(b) is established—invalidation of the resulting deficiency is the appropriate remedy. Respondent's purported distinctions —that petitioner had voluntarily furnished its previously examined records to the second agent and that the first agent had not learned of the quality bonuses—go to the question of whether the taxpayer can complain of a violation, a question not raised here since the Court of Claims held that petitioner had not waived its right to complain.

Moreover, respondent's attempted distinctions are without substantive significance. In each case the second agent obtained access to the books for the previously examined year without disclosing his plans to reexamine that year; neither taxpayer had reason to suspect or to complain of the agent's unauthorized action until it had been completed.* (Pet. 14.) Furthermore, in each case the first agent had full access to the taxpayer's books and thus could have set up the deficiencies subsequently determined by the second agent. (Pet. 32a.) There is nothing in section 7605(b) or in *Reineman* to suggest that enforcement of the advance notice requirement turns on the thoroughness of the first agent's examination.

Respondent's real complaint is with the *Reineman* decision itself; respondent even speculated that the Seventh Circuit would not have followed *Reineman* in this case. (Resp. 14.) That respondent is mistaken in such speculation is evident from the Seventh Circuit's recent statement in *Geurkink* v. *United States,* 66-1 U. S. T. C. ¶ 9144

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*Respondent suggests that section 7605(b) can have no effect where the reexamination has been accomplished surreptitiously because such a reexamination does not "annoy" the taxpayer. (Resp. 12.) It is indeed a novel doctrine that, while a taxpayer whose reexamination is openly requested can object and seek judicial relief, a taxpayer who is subjected to a secret reexamination has no remedy.

(7th Cir. 12/29/65), that *Reineman* stands for the broad proposition that a deficiency assessment "should be set aside because the Commissioner made a *second inspection of taxpayers' books of account* . . . without giving them prior written notice, as required by § 7605(b)." (Emphasis in original.) In view of the conflict between *Reineman* and the decision below and the confused state of lower court precedents, which has engendered a heavy volume of litigation (see 8A Mertens, Law of Federal Income Taxation, § 47.48, notes 88-92.4), the question should be reviewed by this Court.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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PAUL, WEISS, RIFKIND, WHARTON
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ALFRED D. YOUNGWOOD
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January 10, 1966

THE AMERICAN TEXTBOOK PUBLISHERS INSTITUTE

432 PARK AVENUE SOUTH, NEW YORK, NEW YORK, 10016 212-OREGON 9-6488

December 22, 1965

James B. Lewis, Esq.
575 Madison Avenue
New York, N. Y. 10022

Dear Mr. Lewis:

You have asked that I give you a brief explanation of the nature and magnitude of sales of the subscription reference book publishers and their handling of sales commissions.

During 1964 the gross sales of subscription reference book publishers totaled $410,800,000. Approximately 80% of their sales were made on the installment basis, and virtually all of these installment sales were made through sales people employed on a commission basis. Since the sales in this industry are made on the installment basis, with payment extending over a period of from 5 to 10 months, it is customary to recover a portion of the commission where the purchaser subsequently abrogates the contract, signed at the time of sale. Quite obviously, any question relating to the matching of commission expense to the sale is a matter of importance to the industry as a whole.

The statistics given above are based upon the 1964 Annual Survey of Subscription Reference Book Publishers, compiled by the independent accounting firm of Stanley B. Hunt and Associates, under the auspices of the Reference Book Section Statistical Committee of the American Textbook Publishers Institute.

Sincerely yours,

Austin J. McCaffrey
Executive Director

AJM:eg

APPENDIX A

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